House of Commons

Foreign Affairs Committee

Oral evidence: The UK's Relations with China, HC 870

Tuesday 28 March 2017

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Watch the meeting

Members present: Crispin Blunt (Chair); Mr John Baron; Ann Clwyd; Mike Gapes; Stephen Gethins; Mr Mark Hendrick; Adam Holloway; Daniel Kawczynski; Ian Murray; Andrew Rosindell; Nadhim Zahawi.

Questions 1-78

Witnesses

Dr Paola Subacchi, Chatham House, Duncan Innes-Ker, Economist Intelligence Unit, and Guy de Jonquieres, European Centre for International Political Economy and LSE IDEAS.

Stephen Phillips, Chief Executive, China-Britain Business Council, Dr Yu Jie, LSE IDEAS, and Gary Campkin, Director, Policy & Strategy, TheCityUK.

House of Commons

Examination of witnesses

Witnesses: Dr Paola Subacchi, Duncan Innes-Ker and Guy de Jonquieres.

Q1 **Chair:** Welcome to the Foreign Affairs Committee's first formal evidence session of our inquiry into Britain's relations with China. I am very grateful to our witnesses for coming to speak about China's economy and to give us an economic background. I would be grateful if you introduced yourselves for the record.

Duncan Innes-Ker: My name is Duncan Innes-Ker. I am the regional director for Asia with the Economist Intelligence Unit, so I supervise our China forecasts and our team of analysts in Beijing and Hong Kong who do the forecasting both at the national and at the regional and city level in China.

Dr Paola Subacchi: I am Paola Subacchi, the director of international economics research at Chatham House.

Guy de Jonquieres: My name is Guy de Jonquieres. I am a senior fellow with ECIPE, a Brussels-based think tank, and an associate with LSE IDEAS. Before that, I had a long career with the *Financial Times*. My last two jobs there were as the Asia columnist and commentator and before that world trade editor.

Q2 **Chair:** Thank you very much. Plainly we are in very good hands; the only thing against us is the clock. I hope that we will conclude your session by 4 o'clock. We have questions in about six or seven different areas, each of which will be led by a colleague. This session is inevitably a summary of the things that we ought to be paying attention to, so I encourage you to be reasonably pithy in your responses. If someone has said something that you agree with, there is no need to add to that unless you want to place a different emphasis on the answer. If you disagree with someone's analysis, it would be particularly helpful to say that; it would indicate to the Committee where the analysis is in the academic and expert observer community in different places.

I will lead off by inviting you to tell us what you think the Chinese leadership are trying to achieve with the economy.

Guy de Jonquieres: In short, stabilisation—do not do anything that could rock the boat in the run-up to the critical national party congress in the autumn. The consequence of this could actually be destabilisation, because it has led to an on-off policy of keeping the economy going with ever-larger doses of credit, raising China's debt still higher. It perhaps also explains the stalling of the reforms that were announced in late 2013. I think that, unless some huge shock intervenes, there is not going to be very much change in policy over the next six to eight months.

Dr Paola Subacchi: There are two challenges. One is to rebalance the growth model with much more focus on domestic demand and somehow to deal with the overcapacity—in particular, the big concern is unemployment. The other big, long-term structural challenge is the banking and financial reforms, which tie in with many of the initiatives. In reform, China has an incremental modus operandi, so particularly in the financial and banking sector there have been many gradual reforms, particularly on the interest rate, which changed completely the approach of banks that are very tied to the state-owned companies. It also helped to internationalise the RMB—their currency.

Duncan Innes-Ker: I agree with all of what has been said. I would add that it is particularly interesting at the moment that, in many respects, the economy is not the main focus. As we said, stabilisation is the short-term goal. The key focus is political, in terms of improving the functionality of the party and the government system. I think we are seeing, under Xi, a shift from a reliance on state systems towards party systems of running things, which obviously has great implications for economic policy, but economic reform is not the driving goal of that.

Beyond that, I think we are looking at things such as the target of moving towards a moderately prosperous society by perhaps 2021. There are a lot of dates being thrown around: 2020 is the five-year plan target, 2021 is the anniversary of the party and 2025 is the date that is being thrown around in the Made in China initiative. There are all these key dates wandering around in the medium term. Within that last one I would draw attention to moving up the value chain, which is a big goal of the leadership at the moment.

Guy de Jonquieres: May I add one quick point there? I think politics and economics are driving in divergent directions in China. Most reformers would agree that the measures that were announced in the reform package are ones that require liberalisation and a retreat of state intervention. However, politically Xi Jinping has presided over a huge extension of the party's role in a variety of ways. One always has to remember that the right to control is absolutely key to the party's thinking. I think that at some point those two are going to become unsustainable—I don't know when, but they are clearly not mutually consistent.

Q3 **Chair:** Does that mean that the 2016-2020 five-year plan is likely to be unachieved? How ambitious is it, and what are its prospects for success if you have divergent political and economic strategies?

Guy de Jonquieres: Of course, the five-year plan will tend to reflect the priorities of the leadership rather than necessarily what economists would suggest is the best policy for the economy.

Dr Paola Subacchi: The targets are achieved normally, and they need to be achieved. Basically, the economic policy is driven by the target. If there is 6.5% GDP growth target, that will be achieved, and they will achieve it by whatever means are necessary for driving that target. There is not discrepancy between the politics and the economics in that sense. The plan is there and it is what is driving the policy thinking of the leadership.

I would like to add an element that is very important when thinking of China in both economic and political terms: the environment. The environment is a big driver of current policy making. There is a lot of pressure because, particularly in the big cities, people feel that pollution is at very high levels. The leadership has been driven, even on the international stage, and I would say it has so far played an effective role in, for example, the climate targets in the Paris agreement. Their main policy initiatives revolve around the environment. For example, the whole area of green financing, which was the innovation that China brought to the G20 last year, is driven by the idea of sustainability. China realises—and the leadership realises—that they need to make the whole country more sustainable and clean up the environmental mess made in the past when the speed of industrialisation and growth was the main concern.

Q4 **Chair:** Mr Innes-Ker, you talk about China going up the value chain, or trying to. What will that mean, if it is successful, for the sectors of the world economy in which China will have the biggest impact over the next five to 10 years? Is that a sensible timeframe with which to make that judgment as to where China is going to impact globally?

Duncan Innes-Ker: Things change very fast, so 10 years out is probably about as far as we can be at all comfortable with throwing things out in terms of projecting the impact. They have a number of targeted sectors on which one can go into in detail, but for me the ones that seem to be the most impressive globally are, first, the environmental ones. We have already seen the impact of China with its environmental push on sectors like green energy. That impact is already apparent and will be even more so in the years going forward. We have really only just started to see China's impact coming through on new energy vehicles. China has a long way to go with the technology on that front, but its commitment in policy terms is abundantly clear, and the targets are quite phenomenal in terms of the scale in the market that it is looking at.

Those are the ones that will have, I guess, a positive impact. More controversial impacts are likely to come through efforts to move up the value chain in things like microchips, where you will see competition with established players in developed markets—industrial robots and those sorts of areas. These are areas where a lot of Western companies, particularly in places like Japan, the US, and indeed the UK, have what they view as being core competencies that they want to protect. So in terms of the stress that China will create on the international scene, those are more likely to be the stress points.

Q5 **Chair:** How vulnerable is the Chinese economy to American protectionism or a global downturn?

Duncan Innes-Ker: China is a big beneficiary of global trade and open global markets. If there was a serious US move to unsettle the global trading system, China would be one of the biggest sufferers. I know the proportion of China's exports relative to the size of its economy has come down, but I still think that the vulnerability is there.

Guy de Jonquieres: May I go back to your previous question? We know where China wants to be by 2025; it has all been set out in a very far-reaching document called *Made in China 2025*, which is inspired by a German programme of a rather more modest nature. This is causing increasing concern for a number of China's trade partners, particularly the European Union. The parts of it that worry European companies are that it would require intensification of mandatory technology transfer and it would limit the role of foreign companies. The EU chamber of commerce in China produced a really hard-hitting report on this very recently, which I would recommend if you do not know about it already.

One of the consequences of this is that it is now starting to give impetus to a move that a year ago I would have said would not happen: the Europeans adopting a screening mechanism, similar to CFIUS in the US, for Chinese investments. What has really given this thing legs is the fact that the Germans are now behind it, which is interesting because Germany was always China's partner of choice in Europe. What did it was the takeover by Midea, a Chinese company, of a leading German robotics company called Kuka. That has started to cause a real backlash.

The second reason for it is that the talks between the EU and China on a bilateral investment treaty are stuck—they are deadlocked. One of the reasons they are deadlocked is because China is absolutely refusing to give any improvement in market access to foreign companies operating there. So there is definitely a turning of the tide, I think, in the EU.

Q6 **Mr Hendrick:** Can you tell us what CFIUS is?

Guy de Jonquieres: CFIUS is the American screening agency, which I think sits under the US Treasury. It has been around for a while.

Q7 **Chair:** That is very helpful. My colleagues will pick up all these themes and questions, possibly also in the second session we have, which is on British-Chinese relations. Your general expertise on China is what we are investigating here.

I have one final question on China generally. Having travelled around China for three weeks on holiday in August 2015, I was struck by the ghost cities—the astonishing number of empty apartment blocks that are around every city. Surely that is the physical manifestation of astonishing over-construction, which is going to lead to a crash in property prices at some point. Economically, what is going to happen to China, given what it has done with 20 million to 45 million empty residential units?

Guy de Jonquieres: I have heard people coming back from China saying that almost every year over the last 10 to 15 years. Hugh Hendry, the fund manager, famously came back and I think did a whole television series about it. The most famous case is a town called Ordos in the north-west of China, which was a totally empty city; however, I am told—you might know better than me—that it is actually filling up; people are moving in. You are right, though; what has driven the Chinese economy is not exports. It is largely construction, and if construction goes down, one of the main engines of the Chinese economy will slow down.

Dr Paola Subacchi: I think we need to be a bit careful here because Beijing and the first-tier cities are still booming. Prices are rising and there is more demand than supply. Then there are the second-level cities, where all the supply and demand match. Then there are the third and fourth levels, where there is actually excessive supply.

I did a very interesting tour of the area around Hangzhou, and what I observed is that the authorities are trying to channel people and somehow control the employment and the activities around cities that are at the moment empty. For example, around Hangzhou, there is a whole development that they call something like the seat of happiness, which is all built around the theme of e-commerce. There are e-commerce start-ups provided and supported by the Government and the whole city is built around that. Those start-ups somehow channel into Alibaba, which is a multinational company—it is Chinese, but is listed on the New York Stock Exchange and has become a multinational company. Alibaba is quite close to the Government and the authorities. So there is a way to somehow channel the supply of housing in a sort of policy-driven attempt to avoid—

Chair: I am going to move on. I am going to self-limit the answer to my question in order to get through the vast range of stuff we want to.

Q8 **Ian Murray:** We have talked a little bit already about China's strategy for growth and where they want to grow economically. They have obviously driven global growth for the last 10 or 15 years. Given the economy has slowed down significantly, do they still see themselves as the driver for global growth, or are they focusing much more on their own domestic market?

Duncan Innes-Ker: From my perspective, China is the key driver of global growth, although whether they see that as a responsibility—they are always more focused on their own economy. The challenge at the moment is that the political imperative is to meet this target that the President has set of 6.5% real growth a year, but realistically that is probably too high given what is going on with the economy and what is going on with productivity developments within the economy. As a result, you end up with a lot of these strains building up. One suspects that, inevitably, the resolution of those strains will end up bringing growth down and China will be less of a growth driver, but still only the US can compete with it in terms of impact at the global level, and even then China is still the biggest driver at the moment.

Q9 **Ian Murray:** There is concern that 6.5% is the target and it will always be met regardless. Do you think the figures are robust enough for a proper analysis?

Duncan Innes-Ker: I would share those concerns. There is a lot of evidence of data fakery at the moment, and it has clearly been getting worse. There tends to be a constant tussle between the Ministry of Finance and the NDRC over control of statistics, and we have seen it move back to the NDRC recently, which has seen more concern about meeting the targets than about sound policy. There is a lot of evidence that the data faking problems have got worse.

Guy de Jonquieres: The targets are always met. Whether the growth actually corresponds to them is quite another question.

Q10 **Ian Murray:** But where do you think the growth rate might sit?

Guy de Jonquieres: I have heard estimates ranging anywhere from 3% to 4.5%. You know about the Li Keqiang index, which uses electricity consumption, transportation and so on. There is clearly inconsistency between the GDP figures and what those measures show. One has to remember that it is terribly important for the party to show that it is delivering.

One of the easiest problems to solve is that of the growth target by abolishing it, because it has had completely unintended consequences. It was put in place originally because it provided an incentive to the provinces and the municipalities to go all out for growth when headline growth was what mattered. Into that was built a whole incentive structure for promotion for cadres within the Communist party. It has now become not only obsolete but actually counterproductive, because it leads, first, to overshooting and some pretty bizarre practices and, secondly, quite evidently—we have firm evidence of this—to falsification of data. The governor of Liaoning province, which was Li Keqiang's province when he was a governor, announced earlier this year that the fiscal revenue figures had been grossly inflated for four years from 2011.

Q11 **Ian Murray:** If the actual growth rate is significantly different from the published growth rate, does that lessen the consequences of a slowdown for the global economy?

Guy de Jonquieres: I think you need to distinguish between growth and demand. China has been a big driver of global growth; it has not overall been a big driver of global demand, because until recently it had a massive external surplus. If you have a massive external surplus, you are subtracting from demand, not adding to demand. That said, certain groups of countries did benefit specifically from that demand, obvious ones being the resource producers, which are now feeling the chill as China's domestic demand has subsided—look at Brazil and Australia.

Duncan Innes-Ker: It is worth adding that many exporters are big beneficiaries, even within countries whose overall trade balance has been negatively affected. Many companies have enjoyed tremendous growth in sales.

Q12 **Ian Murray:** Dr Subacchi, you talked a little about environmental problems being some of the structural vulnerabilities. The Chairman mentioned some of the empty cities, and there was mention of protectionism. What are the other structural vulnerabilities in the Chinese economy?

Dr Paola Subacchi: The main vulnerability now is the financial sector; that is where the big challenge is. What China needs to do in the next 10 to 20 years to make its economy a fully fledged, advanced economy. The leap forward in real terms has not been matched by the financial sector and the banking sector. China's whole model is predicated on this financial repression, and that explains why China has a very high saving rate at the household level and a very high level of debt at the level of provincial government and state-owned companies. Households and individuals provided cheap capital for the development of China, and that has been going on for 30 years.

Now China wants to become a modern financial economy so that the real economy side is matched with the financial side. That is very difficult, primarily because there is a strong link between state-owned companies and banks. Banks provide money and capital to state-owned companies for non-productive and non-profitable projects. They need to sever that link. The same is true with the provincial governments.

One of the proposals that the monetary authorities are very interested to consider is for some of the best and most profitable provincial governments to issue their debt on the international markets, such as in London. That will mean that somehow they will have to be rated and have to match the regulations, the law, the transparency and the governance of international markets. That is the way of thinking, because the Chinese are very conscious that their system is not strong enough. They are conscious of that point, and they have now explicitly introduced capital controls exactly to protect a very vulnerable banking and financial sector.

Q13 **Ian Murray:** There is a significant amount of Chinese investment across the entire world. Does that financial insecurity, if you like, make that a real concern for international partners?

Dr Paola Subacchi: There is not so much, actually. In absolute terms, there is much more foreign direct investment coming from Europe and the United States into China than vice versa. China has been becoming a more active investor in recent years, but the numbers are still tiny—we are talking about $20 billion in the regions around China, for example, so it is really tiny, but they are becoming more active.

There are a number of concerns. One is investment. They need to be profitable, but sometimes strategic and foreign policy considerations are more important than purely financial issues and business profitability. There is also the aid that China gives to some countries. Recently, particularly in the case of Zimbabwe and Venezuela, China has been less keen to loan. With Zimbabwe in particular, those loans were becoming a loss, and the Chinese wanted to draw a line under that.

The problem they have now is that they loan in dollars. That is a problem for them because effectively they take up exchange rate risk. That is why they are very keen to make the RMB a more international currency and use it for finance to invest abroad or for aid.

Guy de Jonquieres: On your question about growth, in almost any scenario China's growth rate is going to slow down or remain very much lower than we have seen in the last 30 years, for two reasons. The first one is that the amount of debt is huge. The official figure for non-performing loans at the banks is about 3%, but most people reckon it is nearer to 20% to 25%. The thing about non-performing loans is that you never really know until a crisis strikes, because then you get financial distress and the numbers zoom upwards. That is going to have to be cleaned up. Every month that goes by keeping the economy going on injections of credit, the bigger the mess.

It is a much bigger problem than that, though, because much of the growth has been outside the banking sector in credit. All these weird, exotic and extraordinary things—wealth management products are one; repos are another. They are the sort of thing that was being invented on Wall Street in 2006-07. This runs into trillions. There is an enormous cost. I am not saying that the financial system is going to collapse; it won't, because it is state-owned, but there will be a huge bill to pick up, which we know from experience will depress growth for years to come.

The second reason is that if the Chinese do finally grasp the nettle and get on with reforms—we are talking about predominantly structural reforms, the one thing we know about structural reforms is that it is short-term pain for long-term gain. You will remember that after Thatcher launched her structural reforms here, it was about five years before they really started to bear fruit; the growth rate was very weak. That will also happen in China; it is bound to. That is another reason why the leadership is in something of a dilemma.

If China did 3% to 5% and it was the right sort of growth, that would be fine, but to be the right sort of growth there would have to be a wholesale rebalancing of the economy that simply has not happened yet. What we have seen is a downturn in investment and a downturn in the growth rate; axiomatically the share of consumption goes up, but that does not mean to say it is rebalancing to a consumption-based economy.

Dr Paola Subacchi: That is possibly too pessimistic a view of China. First, we need to see the slowdown in the growth rate as an adjustment, and it is a positive adjustment. In the years when China was growing at a double-digit rate, there was a strong acceleration and a lot of overheating, so bringing down the growth rate is actually positive. I saw numbers published by international organisations. The discrepancy between the official numbers and the effective numbers is probably in the range of 50 to 100 basis points. We talk about 6.5%; we can probably go down to 5.5%.

China has a lot of resources and a lot of controls on the whole economy. For example, there is a new initiative—the One Belt, One Road initiative. Nobody knows exactly what it means, but the Chinese are investing in political and economic terms. It means infrastructure investment in the region outside China. That has already brought on board many countries in the region and in Europe. That is a way to export over-capacity, to invest abroad and to push infrastructure investment. In 2015, China launched the Asian Infrastructure Investment Bank, with exactly the purpose of pushing infrastructure investment.

Q14 **Ian Murray:** Do we really understand what is going on with China's economy, or are we just trying to feel our way through what we think we know? We don't really know exactly what is happening and where it will go.

Guy de Jonquieres: Nobody really understands. The people I listen to most are the ones who point out, "This is what we do know," and there is an awful lot. Someone like Michael Pettis at Tsinghua University, who is very good, or Arthur Kroeber at Dragonomics, will always say, "Look, this is what we don't know. But from what we think we know, we can build these conclusions."

Duncan Innes-Ker: I would say that there is an awful lot of data on the Chinese economy, and increasingly companies have an awful lot of data coming out from their numbers. One can usually pull together a picture, and I suspect that in the financial sector, for example, regulators have quite a good idea of what is going on. It is very difficult trying to build these individual data series into a cohesive overall picture.

Q15 **Mike Gapes:** You have mentioned the One Belt, One Road initiative; I was in China last year and there was a great deal of talk about it. Is it primarily economic, or is it more political and about influencing neighbouring countries in central Asia in particular?

Dr Paola Subacchi: There is nothing in China that is political and the economy is not separated from politics; they are all the same thing. It has a very strong political dimension.

Duncan Innes-Ker: It is one of the areas where Chinese companies have a strong competitive advantage in building infrastructure. We know that they are good at that, and they have a lot of experience in China. It has a lot of dollars at hand in the state coffers. The initiative is really the Government putting those two together and saying, "We can do a lot of business overseas with our own selves financing it." It keeps the Chinese occupied, provides good, creative use of their things and offers political benefits and wider economic benefits in building markets overseas for Chinese goods.

Guy de Jonquieres: There are other motives, too, if I may just interject. It is not just infrastructure; I think it would be wrong to portray it as being entirely infrastructure. In the Chinese view, infrastructure is there to create a kind of nexus of industries and activities along the Belt and Road. It is also regarded as a way of trying to expand Chinese standards. The Chinese tried to do that in China with mobile telecoms and it failed; they are trying it again, which is one of the reasons why the telecoms companies are in the vanguard of the people being pushed to go into Belt and Road. And quite a few companies are being pushed. When asked about it, the head of one SOE told a good friend of mine in Beijing, "I call it one belt, one trap." It is very high risk.

Another driver is energy security. The Chinese feel it is safer to bring oil or raw materials by land rather than by sea. Undoubtedly, some of these places, and one thinks of Gwadar in Pakistan, are likely to be dual use. In other words, there will probably be naval-basing facilities there. China has just announced its first overseas naval base in Djibouti, and it has something that could be dual use down in Sri Lanka. If you look around, there are three or four of these different developments. The final element of it is certainly a wish to extend Chinese influence in neighbouring countries, and that is what people in those countries are quite sceptical about.

Q16 **Mike Gapes:** May I just try and unpack this, because there are a lot of different points. You mentioned a naval base; the Indians refer to a string of pearls.

Guy de Jonquieres: It is an American term, not a Chinese term.

Q17 **Mike Gapes:** I have seen it in an Indian description of concerns about Chinese foreign policy in Sri Lanka, Pakistan and so on. Is this potentially going to lead to some tensions militarily?

Guy de Jonquieres: Undoubtedly, I would have thought. Well, not undoubtedly, it could clearly potentially, yes. They are there for a reason, and China clearly wants a blue water navy. Usually, when rising powers develop naval capacity, it does create frictions, and we see already in the South China Sea those frictions with the Americans.

Q18 **Mike Gapes:** Getting back to the issue of capacity, how much is this a desire to keep people in employment in China for the reasons of internal stability? Therefore, if you have factories turning out cement or steel, you basically use that output through road construction or other major construction projects in other countries because your domestic demand has fallen back a bit.

Dr Paola Subacchi: The unemployment rate is a very important concern. The Chinese say that finance should serve the real economy, and to some extent they say that capital and the available surplus should be used to expand the economy to avoid unemployment and overcapacity, because that creates social tensions.

Guy de Jonquieres: But what is being talked about currently in Belt and Road is not exporting the product but exporting the actual capacity, and almost certainly with it a great deal of Chinese labour, because everywhere where the Chinese have put in production and infrastructure abroad, that has employed a lot of Chinese workers and equipment.

Q19 **Mike Gapes:** They have done that for several years. I remember going to Angola years ago, and there were Chinese workers reconstructing the railways.

Guy de Jonquieres: Exactly.

Duncan Innes-Ker: The numbers are small though. Relatively speaking, these are big, capital intensive industries, and they do not employ a lot of people by comparison with the size of the Chinese labour market. Although there is certainly an aspect about exporting capacity and labour, it is not really having an impact on the wider Chinese economic issues.

Q20 **Mike Gapes:** I understand that there are about 900 projects covering more than 60 countries. How many resources are going into this? Given your previous answers about uncertainties of statistics and so on, how much investment is being made?

Guy de Jonquieres: Nobody knows the answer. James King on the *FT* has been trying to work out a number, and I have been trying to discourage him from doing so. It is as long as a piece of string. When you get an all-powerful leader saying, "Do this and there's going to be money," it is amazing what comes out of the cupboard. Schemes that have been shelved for years suddenly get rebadged as Belt and Road. As far as I know, and you may know better, Duncan, I do not think that any overall envelope figure has been set for it.

Dr Paola Subacchi: There isn't, but the Asian Development Bank estimated the gap in infrastructure capacity in the region as about $1 trillion. The Chinese see the Belt and Road as a partnership between the private and public sectors. They are very happy for market forces to occupy some of those areas, and in fact they explicitly invite private and public partnership. There have been a lot of discussion with UK, for example, as a means to set up some of those partnerships. It depends whether the markets will bite into the projects, but some of the development banks, particularly EBRD, are already quite active in this space. There is a very interesting opportunity out there for those with an appetite for risk, because some of the countries in the Belt and Road region are not even ranked in terms of risk, but there is an interest in opportunities. Some of the countries are under the remit of the EBRD, not the Asian Development Bank, because that is very much under the remit of the Japanese and the US. However, the new Asian Infrastructure Investment Bank is very active, as well as various companies.

Q21 **Mike Gapes:** You have talked about opportunities. What challenge would such projects pose to our Government and our country, or other European countries?

Guy de Jonquieres: I am not sure that I am quite as convinced as Paola about the openness of the Chinese to this. There is a Chinese project for a high-speed railway to run between Serbia and Hungary, and it has hit the buffers, temporarily at least, because the Chinese basically wanted to take all the business from it. They were reminded by Brussels—rather abruptly, and not for the first time—that the EU has competitive tendering laws, and you cannot reserve contracts to yourself. That happened before, in discussions with the 16 plus one grouping. It is extraordinary how the Chinese, who are very often so smart, can also be forgetful. For the moment the project is on ice, because the Hungary bit obviously would be subject to EU rules.

Q22 **Mike Gapes:** Is this a general challenge—that the Chinese have values and ways of approaching business that run contrary to the way EU and other countries do it?

Guy de Jonquieres: I was recently in Singapore for a conference on this, and there were quite a few misgivings in south-east Asia. They do not have those rules, obviously, but they are concerned that the Chinese are in it to eat their lunch, basically.

Duncan Innes-Ker: There is a concern on this side, but on the other hand I would say that institutions such as the Asian Infrastructure Investment Bank, which is clearly at the heart of the One Belt, One Road programme, have been keen to stress the governance side of things, in part thanks to influence from countries such as UK and their concerns about that aspect. We saw the AIIB, at least in its initial phase, promise that in its early projects it would always collaborate with partners, so it could learn those lessons from institutions such as the APB. There are clearly concerns I the background, but I think one can overstate them.

The bigger concern to me is that at the moment you are offering a lot of cash to regions and Governments that are perhaps, in some cases, keener to launch projects and borrow money than they are to achieve the end result that other development institutions might be after. The risk is that there may be a need to pick up some pieces in some places, particularly in weaker governance places such as Pacific islands and other types of economy that have been offered a lot of money—

Mike Gapes: And they do not have the capacity to manage it.

Duncan Innes-Ker: Exactly.

Q23 **Mike Gapes:** Dr Subacchi, you mentioned the renminbi earlier. What opportunities do you think there are for the UK to capitalise on the internationalisation of the renminbi?

Dr Paola Subacchi: London has an RMB market of its own; it is tiny. It has been developed in partnership with the PBOC—the central bank of China. It is not possible to develop an RMB market without partnering with the Chinese monetary authorities, because there is no liquidity for this currency. We published a paper—I have a copy if you are interested—on how RMB internationalisation and the Belt and Road initiative can be an opportunity. The London market, particularly the skills and expertise in project finance, can be very helpful to the Chinese, and the Chinese are looking to London as a leading financial centre for the capacity and skills they do not have and they want to learn.

The key problem for the Chinese is to push the RMB outside China while maintaining control in the domestic market. Belt and Road could be an opportunity, if it is structured the right way, to push more RMB-denominated investment in the regions, using the London market as a way to innovate in that sort of project finance.

Q24 **Mike Gapes:** Has that been affected by uncertainties following the referendum last year?

Dr Paola Subacchi: The Chinese always ask what will happen to London as a financial centre, but again this is actually an opportunity for London to offset some of the impact of the referendum and develop. Chinese finance will take a long time, but China wants to be on the same level as the other key economies and currencies.

Chair: May I ask colleagues to pick up the pace slightly, so that we can keep to time? We are all guilty.

Nadhim Zahawi: I will do my best. In January, at the World Economic Forum in Davos, President Xi clearly set out a very positive case for free trade and globalisation, despite China's more restrictive approach to foreign investment. What comment would you make on this new stance the country seems to be taking as a champion of free trade and globalisation?

Guy de Jonquieres: They are seizing an opportunity created by President Trump, I think. As for being able to deliver on it, there are a lot of reasons to question that. China's position on its own trade policy has been hardening, not softening. It is trying to push this regional comprehensive economic partnership, which was originally an ASEAN initiative, but I think it will find it quite difficult, for a variety of reasons.

First, there is the spread of countries in the RCEP. The richest, Singapore, is 50 times richer than the poorest, Cambodia, and we know that it is difficult to have much liberalisation in such circumstances. Secondly, India is in there, and there has never been a trade liberalisation move that India did not dislike. The country is not open to liberalisation, and it is the other really big country in the group. Thirdly, there is a lot of mistrust of China among other partners in RCEP, particularly in south-east Asia, which is split. Cambodia and Laos are in the Chinese camp; Singapore is in the currently very awkward position of having to balance the US and China; and many of the other countries are torn, especially as a result of the confusion created by President Trump's announcements—I won't call them politics.

It was brilliant PR—the whole of Davos is brilliant PR. China is going to have to learn quite a lot of lessons if it is to project itself as a leader in some way of an open global trade system.

Dr Paola Subacchi: Don't forget that China is the country that benefited the most from globalisation.

Q25 **Nadhim Zahawi:** I get all that, and I understand the opportunistic approach, as a counterbalance to the "America first" rhetoric from President Trump. Guy has given a good assessment, but perhaps I can ask Duncan and Paola for their assessment. When you answer that question, will you say whether China thinks it is filling a vacuum and there is not much behind the rhetoric, which is what we heard from Guy, and will you enlighten us as to how countries such as the UK can encourage more reciprocity, more substance beneath the rhetoric?

Duncan Innes-Ker: On the one hand, it is great that someone is making the case for free trade in the current global climate. I agree with Guy that China is not a terribly convincing leader on that front, but by announcing those policies publicly, China creates a rod for its own back in many ways, because we can leverage that to try to make the argument.

It is not entirely true that China is not moving forward with liberalisation. It often feels that way, but there are incremental tiny things that have happened in the past few years. Clearly, it would be great if the Chinese could do a lot more. Personally, I am not greatly optimistic, given the current climate, but things change quickly so we should always be flexible for opportunities out there.

We touched on RCEP. It is much more interesting to me that what we are really looking at is a split in the global system, where developed markets are finding it touch to do trade deals, because they are increasingly focused on nitty-gritty elements that are quite difficult to sell to the public, whereas in so-called south-south deals, you are still basically looking at tariff liberalisation, which a lot of those economies can get behind and are quite keen on.

I agree that I am dubious about RCEP and where it is going. It has not been very successful in making even the limited goals that it has had previously come to fruition, but you see a lot of enthusiasm in emerging markets to bring tariffs down, and that is something we can support even if we do not benefit from it directly.

Guy de Jonquieres: May I answer your first question? It is important to remember that the US and the EU, the two biggest economic units in the world, have been applying steady pressure on China to open up, both to investment and to imports, and they have hardly got anywhere. In Chinese eyes the UK is marginalising itself—it is becoming far less useful to China by leaving the EU. China valued the UK as a partner because it was a member of the EU, because it was a voice for liberalism and openness and against protectionism, and because, either by design or by coincidence, it tended in the Council of Ministers to take the Chinese point of view. Now, you talk to people in Beijing and the UK is far less important. I think we have zero leverage over China once we are out of the EU.

Q26 **Chair:** Do you both agree with that rather clear point of view?

Dr Paola Subacchi: I disagree. China has a very specific view of its economic system: it is different from the rest of the world, but it is open and the Chinese feel that they benefited from opening up to the rest of the world. They were the largest recipient of FDI throughout the last 20 years, and that was part of China's development. They bend the rules, but I would not portray China as a country that does not have an open market. There are ways to be in the Chinese market.

The UK accounts for 2% of China's trade, so it is tiny in that respect. In terms of total EU trade, the UK punches below its weight in relation to the size of its GDP versus that of the rest of the European Union, but the UK has a great advantage in being a financial centre. That is what China wants at the moment—not manufacturing. China's relations with the UK are not like those with Germany. There are a lot of joint ventures between German and Chinese companies. I think that finance is the main issue for the Chinese now.

Guy de Jonquieres: But that does not give us leverage. It would only give us leverage if the Chinese wanted it so badly and the British said, "No, you can't have it." I do not see any sign that the British would do that.

Chair: The Committee will come to its own view on how appropriate it is to exercise leverage in policy, which is why we are taking this evidence. To hear both those perspectives is helpful.

Q27 **Nadhim Zahawi:** China joined the WTO in 2001. It has recently started to pursue a more active role within the organisation—for example, by displaying a willingness to bring cases against other WTO members. What do you think China wants to achieve with its changed approach to international trade organisations? Do you think it will be a responsible and constructive partner in such organisations?

Duncan Innes-Ker: China has demonstrated in the past a tendency to go its own way. My understanding is that it has done a number of cases in its years in the WTO, but its bigger clout comes from the fact that when Governments upset it, it tends to respond. We are seeing that in, for example, South Korea, with the Lotte group and some other South Korean companies facing retaliation; in the Philippines, where we had a lot unofficial bars on exports; in Taiwan, where there has been some pressure on tourism companies.

It is worth saying that in a lot of those examples overall Chinese imports from those countries still rise, but certain key points still feel pressure. If China is moving more toward use of the institutional arrangement, that would be great, but I think it has a long way to come before it fully embeds in that. That may be another area where the US retreat is encouraging China to take the institutions and reform them in its own priorities.

Guy de Jonquieres: China is an à la carte multilateralist; it will join in when it is something that clearly meets the party's needs and can be seen to benefit China in a very direct way. To be fair, as a member of the WTO I think it has behaved itself pretty well—certainly no worse than the US and the EU. They tend to stick by their agreements. What Duncan says about bilaterals is course quite another story, and several countries, notably Australia, have seen that their exports to China actually fall after they entered into free trade agreements with China.

Q28 **Nadhim Zahawi:** We touched on the UK relationship and the priority that China puts on that. For the FCO, it considers China to be a key partner at the G20 and other forums. Do you think that there is any chance of conflict between the UK's interests and China's new aims in international trade organisations? How much of China's approach do you think will align with the UK's position in the future, as we look to deepen our relationship with China when we exit the European Union?

Guy de Jonquieres: I do not quite know what our position will be after Brexit; one hears different voices from different interests, so it is a little difficult to answer that. If the UK was taking a position that favoured the Chinese interests in terms of keeping markets open and so forth, obviously China would be pleased by that.

Dr Paola Subacchi: Besides financial services, there are other areas where China values the relationship with the UK. One is education; UK universities are highly rated in China. The so-called soft power of the UK is highly rated. Education, the entertainment industry and financial services are the areas where the UK has a competitive advantage vis-à-vis other EU members and other competitors. It is something that China values very highly.

Guy de Jonquieres: There are two other things. One is buying technology—there are lots of small technology companies in Britain that they can acquire. I would argue that for certain sectors that is probably at least as important as access to the financial market, and that is not going to change. The other one is where most of the money has gone so far in FDI terms, and that is commercial and residential property.

Q29 **Mr Hendrick:** How successful do you think the Asian Infrastructure Investment Bank has been so far? What projects do you think have been the most beneficial? You mentioned the One Belt, One Road initiative, Mr Innes-Ker, so would you like to say a little bit about that? Your colleagues may contribute as well.

Duncan Innes-Ker: The AIIB is moving quite slowly to start up, so in terms of the actual projects, I believe that it announced its first project at the start of the year. In practice, it has been moving relatively slowly and has been keen to let other partners take a lot of the weight on that, partly because it is upskilling itself. To me, of all the new institutions coming out of China, the AIIB looks pretty impressive. The people I have met there seem good; often they are internationally educated, well aware of international standards and quite sophisticated all round. I think I would have quite high expectations of the AIIB over the longer term, and I think by and large the role that it plays will probably be very positive. Sorry, I have forgotten the second part of the question.

Mr Hendrick: The actual projects.

Duncan Innes-Ker: Money for these projects has never been the biggest issue. There have been a lot of Governments, particularly in south-east Asia, which is where I think the AIIB has the greatest potential to have impact, put aside very large sums of infrastructure cash that they are not able to spend themselves. In many ways, the bigger issue is resolving the problems on the ground that have been obstructing infrastructure development rather than just cash, but clearly it will not be a negative factor.

Q30 **Mr Hendrick:** Will there be an investment in capacity to be able to use that cash? I believe that they have something like $60 billion.

Dr Paola Subacchi: They have $100 billion as equity capital put by the partners or the members of the bank. As a development bank they will raise capital. Again, that is another area where London can help and where they can use the RMB.

The AIIB was announced first—again, it is very Chinese to have a big announcement—and then they spent about a year and a half trying to figure out what to do; so really there was a very gradual and slow process of thinking. The key issue is the governance and the criteria for allocating project money—project capital. Having profitable and sustainable projects has been stressed strongly in environmental terms, but not only in environmental terms. The due diligence around the projects is a key issue for the bank and explains why the process has been pretty slow.

Q31 **Mr Hendrick:** We talked a little bit about President Trump pulling out of the Trans-Pacific Partnership and it would seem that it is unlikely to go forward. I would have guessed that that is a huge opportunity for China either to develop its own ideas further around RCEP, or at least to try to mimic the TPP in a way that favours itself as the multilateral trading partner that the United States does not want to be.

Guy de Jonquieres: It will find it very difficult indeed to replicate or mimic TPP, because, at American insistence, TPP was not really about liberalisation. There is not that much liberalisation in TPP; it is about rule setting. The US was very insistent under the Obama Administration that the rules be set at a very high level that China at that point could not meet. I do not think that was a deliberately exclusionary process—we should give them the benefit of the doubt. It was basically to try to bring China on and say, "Meet our standards." A lot of the standards were irrelevant.

Q32 **Mr Hendrick:** Those standards will drop now as a result of the Americans not being involved, won't they? You will get something more akin to what China wants.

Guy de Jonquieres: You will probably not get many standards in RCEP. RCEP will to a substantial extent be a tariff-cutting exercise. Even there, it is not clear how much tariff-cutting scope there is. First, agriculture will be out of the question; secondly, most of the trade within east Asia is of parts and components. A surprisingly small proportion goes to satisfy domestic demand in the various countries. It is the production chain, and where the production chain is concerned, most countries that are linked into it have already cut their tariffs to a very low level, because it makes no point to cut off your nose to spite your face.

You can measure that by looking at what is called the utilisation ratio of preferences in free trade agreements. The utilisation ratio in many of them in Asia is very low because the tariffs were already low to start with. Why go through all the huge hassle of the rules of origin sort of thing, which we will have to go through if we do an FTA with the EU—that is very costly and very bureaucratic—when the gains are very small?

Q33 **Mr Hendrick:** So are you saying there is not necessarily any great benefit in the Americans dropping TPP, because RCEP is a fairly pale imitation or version of it, anyway?

Duncan Innes-Ker: Let's be clear: RCEP in its conceptual design is to spread existing free trade agreements within the members, mostly around the ASEAN and its various partners, making those spread over. What would be interesting is if China took that concept and tried to run with it and turn it into something else. At the moment, that does not seem to be the case and they are struggling to spread even existing agreements to further partners. As I say, they have had numerous meetings that have failed to meet the goals and aspirations that were set for them on RCEP. I personally suspect that it will come to a conclusion at some stage, but not for many years, and it will probably not be a terribly impressive agreement when it does come to its conclusion.

Q34 **Mr Hendrick:** What are the obstacles? Mr de Jonquieres was saying that tariffs are pretty low anyway. There is little in the way of standards, so what barriers are there? What are the difficulties?

Guy de Jonquieres: If the Chinese had tried to impose Chinese standards on it, I think they would run into a lot of pushback from the Japanese and the Koreans, for a start. That would not fly. If they are going to take ownership of it—it is still officially an ASEAN project—they are going to have to make quite a lot of compromises themselves.

Q35 **Mr Hendrick:** How would you describe the trade and investment relationship between the EU and China at the moment?

Guy de Jonquieres: As I said, the BIT talks have stalled. The Chinese have said they would like a free trade agreement, but they blow hot and cold on it. I have just been in Brussels, and the view there was that if that comes to anything, it will be at least the next Commission before it gets under way. I spoke a bit about the investment relationship and the ideas floating around for a new European CFIUS. The trade relationship is always a bit tetchy, but there have not been—correct me if I am wrong, Duncan—any really big friction points; nothing like the solar panels issue.

Q36 **Mr Hendrick:** What about steel?

Guy de Jonquieres: You're right—dumping and MES, obviously, are very important. Of course the Chinese are challenging the Americans and the Europeans in the WTO disputes procedure. We will see where that leads to.

Q37 **Mr Hendrick:** What about the need for China to become a functioning market economy?

Guy de Jonquieres: That is what I meant by MES. Sorry, I should have spelled it out: market economy status.

Q38 **Andrew Rosindell:** Hong Kong is of particular interest to myself and other Committee members. It is nearly 20 years since the handover from the UK to China. Do you feel the Hong Kong economy has benefited from becoming part of China?

Guy de Jonquieres: The Hong Kong economy is in a bad way at the moment. The latest figures I saw showed that the growth rate is going to be lower than Britain's, at about 1%. It obviously benefited in the early phases because of all the initial public offerings—particularly bank IPOs—that were floated on the Hong Kong exchange, and as a gateway into China. The IPOs are no longer happening on anything like that scale, and there are other gateways into China.

It is suffering because—well, it depends how helpful you think a real estate boom is. Huge amounts of Chinese money flooded into Hong Kong, buying up everything in sight and creating one of the main reasons why the Occupy movement attracted wider support. There was a lot of anger about that and about Chinese coming down and filling up hospitals and schools—mainlanders, I mean—with Hong Kongers complaining that they were being squeezed out of their own patch of land.

Another thing that is difficult is the dollar peg, which is now over 20 years old, I think. That has made Hong Kong less competitive. It has always been a bit of a struggle keeping the peg going.

Now, if you asked Hong Kongers what had been the benefits of having closer relations with the mainland, I am not sure you would get a tremendously enthusiastic response.

Duncan Innes-Ker: I disagree quite heavily with that. There have clearly been winners and losers. Hong Kong's growth rate is obviously driven by global trade flows, and it has been a very bad time for global trade flows in the last few years. That is one of the reasons why they are performing so badly. In terms of household consumption and income levels, there has on average been a much more positive performance. That is clearly benefiting from the integration with China. I think the question, "Is it benefiting from being a part of China or not?" is a bit moot, because we are where we are. It is becoming more of a normal Chinese city, but it is part of China and the understanding was that after the transition period that was what it would transition to.

A lot of tensions are being generated by the lack of political reform within China, which has limited the potential for political reform within Hong Kong. There is the increasing tendency in the past few years towards control by the mainland Government, which has extended over the border into Hong Kong. Above all, there is the tension between young people and older people. It is quite extraordinary: if you look at the support ratings for the Chief Executive, among young people, it is 96% disapproval versus much more moderate levels in older age groups, and that clearly ties back into the property problem. That has been a clear crisis point for the Hong Kong economy, but the failure there is as much on the part of the local political leadership as it is anything to do with integration with China. I think the local leadership in Hong Kong has been very poor at tackling issues to do with the housing market.

Q39 **Andrew Rosindell:** But you said there were winners and losers. Who specifically are the winners and who are the losers?

Duncan Innes-Ker: The winners would be the vast majority of people who are asset holders. Anyone who has owned property in the last 20 years has done phenomenally well. The vast majority of people in employment have been winners. People over 35 have probably on the whole been gainers, but clearly young people are really suffering and are unable to meet the aspirations that their parents' generation would have had.

Dr Paola Subacchi: I agree with Duncan. Hong Kong has become a Chinese city and is being more and more integrated with the mainland. The interesting thing is that the two main industries are finance and logistics, and logistics has been helped a lot by Hong Kong being part of China with one country, two systems.

Finance has been very much helped by being part of China, but in the long term that is where the risks are. The Chinese leadership in Beijing has always made very clear that the international financial centre of China will be Shanghai and not Hong Kong, and there are tensions between Hong Kong and Shanghai on that. Hong Kong will be even more integrated with the mainland, and eventually it will have to shift to the RMB as opposed to the Hong Kong dollar—that will eventually happen. They will then have lost their leadership as an international financial centre. That is where the vulnerability is.

Q40 **Andrew Rosindell:** To what extent are China's debt problems having a knock-on effect on Hong Kong?

Duncan Innes-Ker: There is lending by Hong Kong banks within China. The Hong Kong Monetary Authority, which effectively is the central bank, is all over that in terms of watching it closely and telling local banks to curb exposures and things like that, but in practice growing integration makes it very difficult to restrain that. If China's economy takes a hit, Hong Kong will be right in the firing line.

Dr Paola Subacchi: The links between the mainland and Hong Kong are getting deeper and deeper. There is now the Shanghai-Hong Kong stock connect, which allows Hong Kong and Shanghai to trade directly between the two markets. Loans from Hong Kong can be directed into the mainland market, so they are very integrated.

Chair: Okay. Andrew, if this can be your last question, we can give John five minutes before we wrap this session up.

Q41 **Andrew Rosindell:** How well have Hong Kong's commercial advantages, such as the rule of law and free trade, been maintained since China took over? Are they keeping to their side of the agreement?

Dr Paola Subacchi: Yes.

Guy de Jonquieres: I think the judiciary, so far as I can see, has maintained its independence and integrity, certainly as a commercial tribunal, but also in other civil and criminal cases. I think the interesting test, as more judges retire or die and new judges are appointed, will be whether China tries to influence that process in a way that would lead to the appointment of people who are more favourable to China.

Dr Paola Subacchi: At the moment, paradoxically, the mainland value—Beijing value—in respect of Hong Kong is "one country, two systems", because there are advantages for the mainland for their own purposes, so at the moment they really respect this kind of separation.

Duncan Innes-Ker: I would agree with all that. Obviously there are specific cases that have raised some concerns, but overall the integrity of the legal system is still great. One of the things that does concern me from a longer-term perspective is that nobody has even begun to talk about how you merge Hong Kong's regulatory systems with the mainland's. We are still quite a long way away from that, but it is going to need an awful lot of planning. The official date when "one country, two systems" is meant to end is 2047; at the moment, the gap between those two systems is very wide indeed, and in many ways it is not getting narrower. I am concerned about the long-term planning on that front.

Chair: Okay. John Baron, to finish the session off.

Q42 **Mr Baron:** In the few minutes we have left, may I touch briefly on two issues that we have alluded to in our discussions but have not necessarily drawn out? One is the shift in the economic model from investment to consumption. The other is urbanisation—which, if history suggests anything when looking at other continents, can lead to a growth in democracy—and the threat that it may pose to the Communist party.

Putting the stock market to one side—it is booming at the moment, but that does not always reflect the economic fundamentals; they can be detached—there is now an ageing population, a slowing economy, Government intervention that can be heavy-handed at best and the phenomenal rise in debt that we alluded previously. The figure was something like 160% of GDP about 10 years ago. I know that figures are not easy, but it is up to about 250% now. We all suffer from high debt, but that sounds to me like potentially quite a volatile cocktail.

Can you tell us a little more about your views on the debt? There is a suspicion that there is a lot of debt being hidden, particularly in the provinces, among the banks and so forth. I know that figures are difficult, but have you got any further measure? There is a slowing economy, there is high debt and there is the feeling that cheap borrowing is there to protect or help the slowing economy. It makes for a volatile mix.

Dr Paola Subacchi: The high debt is actually in some sectors; again, it is in local government, provincial government and corporate. There is high surplus among the family. So as long as they maintain this financial repression, there is a way to somehow shift things, so that the one thing pays for the other, basically.

That is why capital controls were reintroduced officially a couple of weeks ago: because the outflow of capital is a reaction not only to the change in monetary policy of the United States, but to people's feeling that they are not getting enough reward for their money, to put it bluntly. Capital controls are a way to avoid exactly that outflow, which can destabilise the financial sector. As long as the authorities can keep control, somehow the system remains in balance.

You mentioned urbanisation. China still has about half of its population in the countryside. The size of its primary sector vis-à-vis the rest of its economy is still in the double digits, whereas in our economies we are talking about a 2% primary sector. Again, this is a big shift. One of the main targets of Xi Jinping's last five-year plan was to move more people from the countryside to the cities. That will also mean an improvement in productivity—like many other countries, China has a problem with productivity growth.

Q43 **Mr Baron:** I want to come back to urbanisation briefly, but first, do you share Dr Subacchi's optimism with regard to the slowing economy and debt?

Guy de Jonquieres: I think the problem with debt is not its absolute size, which is big; it is the speed with which it continues to grow at more than twice the growth of GDP, and the fact that much of that growth is in areas that are outside the authorities' control—all these exotic products. It was an unintended consequence of liberalisation, and I think lessons have been drawn from that in China.

I think they are going to be a lot more cautious about liberalisation of the financial sector, because for perfectly good reasons, they started opening up—they liberalised interest rates, which, incidentally, has reduced financial repression by really quite a large amount—and these things grew like Topsy. You have wealth management products, assets and other products. I mean, it is an incredible mess. Incidentally, I would commend to the Committee an excellent piece done by George Magnus very recently about all of this. He throws a lot of light on it.

Q44 **Mr Baron:** You are cautious.

Guy de Jonquieres: I am cautious. I don't think it is going to collapse. It won't be allowed to collapse.

Q45 **Mr Baron:** Very briefly then, can I move us on to urbanisation? Time is short and we need to move on. We are seeing a massive urbanisation take place. If you believe the targets, there is talk about another 100 million people being moved into the cities by 2020, which may make sense of the Chairman's questions about lots of housing development left empty for the time being—maybe there is a long-term plan there.

If you look at other continents and if you look at history, urbanisation together with a slowing economy can make for increased political demands. How confident are you that the Chinese authorities are going to manage this process—not just an economy that is shifting from investment to consumption, but a population that is shifting from the countryside to the towns and cities?

Guy de Jonquieres: They are obviously trying to get to grips with the environment, but it is a massive task. I was reading today something saying that the reason why there is less smog in Beijing is simply that they are closing down coal-fired generators there and are importing more electricity from elsewhere in the country that is being generated by coal, which is quite interesting.

One of the big things that people don't talk a lot about among the challenges in China is water. Water is becoming an enormous problem. There are large parts of the country where the water availability and the water stocks are well below the UN level. That is going to be a much, much harder one to solve. There is obviously quite a lot of discontent among people about not getting the medical care that they think that they should have, or that the schools aren't good enough. How easy is it for the Party to manage those expectations and to deliver better standards? I don't know. It is a big task. I would hesitate to guess.

Q46 **Mr Baron:** Duncan, very quickly on urbanisation.

Duncan Innes-Ker: I am nervous, because I can see that the Party is nervous. You can already see that from the tightening of controls that they have had in recent years—that they are concerned about what is going on. What is worth saying is that it is very difficult to see where an organised opposition movement would come from.

There is very little in the way of civil society, and what there is, is being clamped down on at the moment. Relative to the level of development, it is very little. The biggest risk is not a steady build-up of pressure for change in my view, because the high level of control means that that seems to be watched closely. The biggest risk is that something happens unexpectedly. If you have lived in China, you are well aware that in these big cities, you can get enormous crowds turning out on the turn of a screw, basically. They are very sudden and uncontrollable and you can get thousands of people turning out. In those sorts of circumstances, frankly anything can happen. I think that is what the Government are concerned about when they think about potential loss of control.

Mr Baron: Thank you.

Chair: Thank you very much indeed. That has been very helpful. We would invite you to continue to follow our work. If there are issues that you think we need more detail on, in addition to the rough skim-over we have been able to do—we were not able to do these issues justice at all today—feel free to submit more evidence to us. I am very grateful, on behalf of my colleagues, for your wisdom and the education of the Committee this afternoon. Thank you very much.

We will now invite the second panel in to focus on the British-Chinese relationship.

Examination of witnesses

Witnesses: Stephen Phillips, Dr Yu Jie and Gary Campkin.

Q47 **Chair:** Thank you very much for coming to give evidence on the UK-China trade and investment relationship. Particular thanks to you, Mr Phillips, because I know that today is not the most convenient day in the world for you to come and give evidence. I am extremely grateful to you for giving us your time. Could you all introduce yourselves formally for the record, starting with Mr Phillips?

Stephen Phillips: My name is Stephen Phillips. I am the chief executive of the China-Britain Business Council, a membership organisation that has helped British companies to do business with the Chinese for more than 60 years. We have 15 offices across China and 11 in the UK. We work very closely with the DIT, the FCO and wider Whitehall, as well as with cities and LEPs across the country.

Dr Yu Jie: Good afternoon, gentlemen and ladies. My name is Yu Jie. I am from the LSE IDEAS China Foresight programme. LSE IDEAS is the foreign policy think-tank of the London School of Economics. My area of expertise is China-UK and China-EU relations.

Gary Campkin: I am Gary Campkin, director of policy and strategy at TheCityUK, which is the organisation that represents UK-based financial and related professional services.

Q48 **Chair:** Let me ask the first question of this session. How important is China as a trade and investment partner to the United Kingdom? Perhaps you could illustrate that by also saying whether China is more important to the UK than the UK is to China and, if so, whether that is a problem.

Stephen Phillips: To state the obvious, as the second largest economy in the world, China is too important to ignore. That is true if you want to do business there, but equally, companies that have no intention of ever doing business in China need to understand what is going on there and what Chinese companies are doing at global level.

I was very struck by the focus in the conversation so far today on slowing growth, but commercially the absolute growth in the economy is much more important, and even at the lower growth rates, absolute growth is two to three times higher than it was a decade ago. That is what is important from a business perspective. Also, those great big macroeconomic figures are not terribly useful to businesses that are looking at doing business in a province or city. Companies have to get much more granular, in terms of the data that they are looking at. National data is not particularly useful for individual companies.

If I may, I will also touch on innovation and Made in China 2025. I think that is a good opportunity for the UK. Yes, there are legitimate concerns, but again, commercially, can you stop the tide coming in? If you can’t, you need to look at where the opportunities lie and, in many ways, make hay while the sun is shining.

The last point I would like to make is that the opportunity is not just in China. With Chinese companies rapidly globalising, the opportunity is threefold. There is continued opportunity in China with the changing economy. There is the opportunity to work with Chinese companies, which increasingly are investing in the UK. And there is the very early stage opportunity at global level of companies partnering together. Belt and Road is part of that opportunity. There, both commercially and economically, the opportunity is huge. B and R represents two thirds of the world’s population, but only one third of the world’s GDP, so, with economic growth in those 65-odd countries increasing to an average level, the commercial and, indeed, global prosperity opportunity is huge. Again, commercially, it is important to understand that Belt and Road does not really have a master plan. There is no definitive list of projects, but if a project fits the Belt and Road criteria, commercially it is very important that it will help to mobilise the Chinese system.

The big opportunities in Belt and Road for the UK at the moment lie in financial and professional services and with our civil engineers. We did some work about six months ago and identified 21 existing projects with a capital value of $27 billion, where UK companies were already gaining fee income from it—so it is very important.

Dr Yu Jie: I fully agree with what was just said about China and the UK as partners. As to the supposed Brexit opportunity between China and the UK, I would argue that we should provide a more nuanced picture to analyse the type of Chinese investments in the UK. On the one hand, we have certain companies looking to set their market foothold in the UK, as well as in the European market. Companies that are looking at the UK as a gateway to the EU may lose interest in the British market. On the other hand, other companies are looking for technological innovation and acquisitions—to buy technologies from the UK—and I assume Brexit affects their companies’ strategy very little.

I come back to Mr Phillips’s point regarding Belt and Road. Obviously the Chinese consider the British market as an important professional services market for Belt and Road. There are so many projects where the Chinese know how to export capacity, but the Chinese do not really have the ideas on how to manage the project from a professional services point of view. The British market and British companies do serve our nation.

Chair: I am going to go to my colleague Mr Kawczynski and then Mr Gethins, who I know both have pressing engagements. You have 10 minutes each.

Q49 **Daniel Kawczynski:** Thank you, Mr Chairman. The Hinkley Point C project is obviously a very iconic and important construction for the

United Kingdom. When there was the change of Administration and the Prime Minister put the project on hold temporarily, some people were pleased by that and hoped it would be pulled because of obvious concerns with regard to security and, quite frankly, how reliable the Chinese would be as a partner in this sensitive area. How would you respond to that?

Dr Yu Jie: I look at it more from the Chinese perspective. The Chinese company, CGN, which would like to invest in this country, considers it an enormous glory to be able to introduce their technology in the British market. They would assume that it is a stepping stone for them to introduce their key technologies and management here. They would consider it more important politically, rather than in terms of economic viability. That is why they want to invest in the UK.

On the other hand, we should realise that the CGN as a company does not really have sufficient expertise and international exposure. It does not really know projects such as Hinkley, which involves different interest groups, such as NGOs and civil society. Those are occupations that they have not really anticipated before. I would consider that they have a lack of experience in managing this kind of high-level project in the UK or the European market. It is a learning process for the Chinese company. The company has only been exposed since 1982, when China built its first nuclear power station.

Q50 **Daniel Kawczynski:** I understand that, but my question was more tailored to the British perspective. Would anyone on the panel like to answer on those concerns? Without being disrespectful, concerns were expressed about having a Chinese partner for something as sensitive as this, bearing in mind some difficulties we have had in terms of security with China, and different political machinations. How would you answer that?

Stephen Phillips: The business community as a whole probably did not share the vast majority of those concerns, whereas civil society had rather more concerns. It shows that perhaps Chinese companies do not sell themselves very well or portray themselves as well as they need to in the UK. UK companies view this as a situation where there is great technical competence that the Chinese bring to the party. The Chinese nuclear industry is in many ways much more advanced than that of many other countries in the world. Commercial people thought that it was not beyond the wit of man for security issues to be addressed by the Government behind the scenes. Furthermore, because of the political importance of the project to the Chinese side, to do anything that would jeopardise China's reputation would go completely counter to the Chinese objective, which was to demonstrate competence at the global level. There is lots of risk mitigation there when you think of it from a purely commercial point of view.

Q51 **Daniel Kawczynski:** I think I have been to some of your events, and I acknowledge the tremendous work that you do. I think that your organisation probably understands Chinese companies better than most.

From your experience, the Chinese Government is obviously very supportive of these projects and does not want anything to go wrong because of its reputation. Is that what you are saying to us?

Stephen Phillips: In the case of that particular project, I think that is absolutely the case. Clearly we are talking about state-owned enterprise. I do not think you can naturally extend that to every Chinese investment. For nuclear investment, the Chinese Government have a vested interest in ensuring that things go very smoothly. Private sector enterprises from China investing here would not necessarily have that sort of political cover from the Chinese system. I just would not extend it beyond that particular case.

Q52 **Daniel Kawczynski:** Let me move on to Chinese foreign direct investment in the United Kingdom. In my constituency, we already see many companies in Shrewsbury, which is a relatively small town, trying to engage with Chinese counterparts and trying to invest in China or attract FDI into our county. Their experiences—the companies that I have engaged with in my constituency—have been very positive so far. From your perspectives, is Chinese FDI in the UK a success story for both sides, generally speaking?

Stephen Phillips: I think we are still at the early stages of Chinese investment in the UK. In sterling terms, the vast majority has gone into real estate. I think that may not be the most productive type of asset to have inward investment into, although we are beginning to see more and more investment into industries that will create value-added jobs. If you look at the automotive industry, we have seen a number of acquisitions or significant stakes being taken by Chinese companies in second-tier players in the automotive industry. That is either assuring jobs in the UK or generating new jobs, which I think is positive.

I think in the longer term, when we see significant Chinese investment going into some of our new-build infrastructure, that will clearly be positive for the public coffers. I think the final main area where we have seen some Chinese investment is purely financial. We have seen some of the sovereign wealth funds taking relatively small stakes in Heathrow and Thames Water, for instance. Is that really beneficial to the economy? I think that is questionable, but it is not harmful.

Chair: Again, I ask for your answers to be brief.

Q53 **Daniel Kawczynski:** I have only three minutes left. How can the UK increase its access to investing in the Chinese market?

Gary Campkin: If I could just pick up on one thought from the last question, it is important to see the internationalisation of Chinese corporates as a major trend. It is important that the UK continues to attract Chinese interest in this country. Something like 50 Chinese companies are listed on the London stock exchange, and we have Chinese banks here. Why are they here? Because London and the UK are the world's leading global financial centre. There are some very important dynamics there about growing trends and continuing to be attractive to international investment.

In terms of trade and growing trade, the reality is that, for both financial services and related professional services, China is a major opportunity—a major market. It is not always the easiest of markets, and that is why it is important that organisations like my own and the CBBC work with the Government to ensure that we can access the market in the best way possible and raise problems when there are market access barriers, which can be quite significant right across the range of business interests, not just in the industry that I represent.

The last point I would make is just to emphasise something that both my colleagues on the panel said earlier about Belt and Road. The Chinese are very interested and do need British expertise, in not just finance but the related professional services—legal, accountancy and business advisory—that are such an important part of the activity we have here in the United Kingdom.

Daniel Kawczynski: Do I have time for one last quick question?

Chair: Yes, 30 seconds—well, 10 for the question.

Q54 **Daniel Kawczynski:** Very quickly, then, Mr Campkin, on the question of the regulatory problems and protectionism in China, what more could our Government do in terms of lobbying the Chinese on that?

Gary Campkin: In the industry that I represent, there is a very effective economic and financial dialogue, which is led by the Chancellor. The last one was in November last year, and it was extremely positive; it raised a whole range of bilateral issues, which we are now taking forward in partnership with the Government.

It is also important to ensure that we use the multilateral trade disciplines that China is signed up to. You were talking a little bit about the WTO in the last session. In my previous career, I was engaged in the very long journey of Chinese accession to the WTO, and it is important that we look at those commitments very carefully. Above and beyond that, we should work in forums like the G20 and other multilateral discussion forums where global rules and standards are set, and make sure that we work, Government to Government, based on deep consultation with the industry, to ensure that the highest standards are set.

Daniel Kawczynski: Thank you.

Q55 **Stephen Gethins:** We have touched on this briefly, but I wonder whether each of you could give your view of how policy makers and business people in China view the UK's decision to leave the European Union. I am happy for any of you to kick off.

Stephen Phillips: I think it caused some short-term uncertainty in the business community and bewilderment within the Chinese political system. From a business perspective, that uncertainty rapidly disappeared, particularly with sterling being so weak, which means the UK has been very cheap, particularly if you want to invest here. In the longer term, though, I think it will become more of an issue. If you look at the UK as a market, it is a very small country—just the size of one Chinese province—so disassociation from the EU may be a disadvantage from a Chinese point of view in the longer term.

Gary Campkin: Could I add some thoughts? It is important to reflect on what Stephen said. Initially, the reaction was exactly as he described. We get the sense that that is now changing, certainly as the Government have reached out. In terms of my industry, there have been a number of very good bilateral contacts from both the Treasury and the Department for International Trade to begin to look through what the futurescape will look like and what that means. The reality in my industry is that a lot of the Chinese interest in the UK is because it is a global international financial centre, not necessarily because it is the jumping-off point to the EU 27; although that is important for a lot of international investors here, is not yet so important for the Chinese. The last point I would make is that that aspect of the relationship will depend very much on the shape of the final market access deal between the United Kingdom and the EU 27.

Dr Yu Jie: To add to what has already been said, the Chinese political elite is extremely concerned about the healthiness of the UK economy. Part of the reason is that China-UK relations are a major diplomatic legacy that Xi Jinping has decided to leave when he leaves office. If a major trading partner decides to leave a major trading bloc, it is a major challenge for him. He has tried his best to save it in order to secure his power consolidation back home, and to save his own face, because don't forget that at the end of the day, face in Chinese politics is an extremely important thing. Prestige and face are probably more important than economic success.

Q56 **Stephen Gethins:** As a follow-up, can I ask what impact you think that has had in China on their view of the UK political establishment?

Dr Yu Jie: Obviously, Xi Jinping, as we know, is in the so-called election year, or the year of party leadership transition. He will have to do whatever he can in order to make sure that the economy is running properly and that whatever numbers are correct. In that case, the UK is an important economic partner, and there are opportunities for the UK to negotiate some kind of favoured terms with the Chinese Government. That is something they are looking for—the unexpected, and turning disasters into unexpected opportunities. I would say that if the British Government want to start to negotiate with China on the balance of free trade agreement or on any other kind of agreement, it is better to start it now, rather than later, because this is a year that Xi Jinping wants to make sure that the economy is running properly. Obviously, the UK is one of the key partners.

Gary Campkin: May I add one thought, which I think is really important in the current political context? That is the commonality of approach on protectionism. The UK has made it quite clear that it will remain a champion for free, liberal and fair global markets, and the Chinese leadership have been very clear about that, too. I was in Geneva fairly recently talking to WTO ambassadors about the new dynamics in Geneva and the WTO. Certainly, the general sense there, including from the Chinese, was that an independent UK trade and investment policy of that liberal, open-minded type would be a very positive thing for the global system as a whole. I think, again, we can look at working together in those sorts of areas very closely in the future.

Q57 **Stephen Gethins:** Mr Phillips, I was interested when you mentioned the long term earlier on. Obviously, it is very difficult to tell in the short term—not least in this week—but in the long term, what do you think the impact will be of the UK leaving the single market in particular?

Stephen Phillips: I think that there is a latent concern until companies know what the landscape is around access, because the UK is such a small market. If you are looking at the UK as a base to serve a wider marketplace, that is obviously vitally important. Because they operate in highly politicalised environments, Chinese companies are also concerned that the UK will not be such a political heavyweight on the global stage. I think that is at the back of people's minds. But this is a long time off for most Chinese companies, who at the moment are probably not thinking that long term in terms of the UK.

Q58 **Stephen Gethins:** Sure. Do you think this will mean a reassessment of China's relationship with other European partners? Who will they be looking to, to become a key partner, if not the UK?

Stephen Phillips: China obviously has a very good relationship with Germany, although that has become a little bit more fractious over recent years. In the earlier session, we heard a particular case in point. I think China will continue to focus on a number of key partners in Europe. It will be determined by whether those countries have the know-how, the technical capacity or indeed the political willingness to engage with China, as China will be in one year, three years or five years; China continues to change incredibly rapidly.

Q59 **Stephen Gethins:** As a final question—this could be quite constructive—what would your advice be to the UK Government? If they are looking to increase trade and investment, and we are where we are in our relationship with the European Union, what would be the bit of advice from each of you to the UK Government on increasing trade and investment in a post-Brexit world?

Stephen Phillips: Consistent and regular engagement by senior Ministers with their counterparts.

Dr Yu Jie: I second that opinion regarding consistency. By Chinese understanding, it seems that they are still very much confused. Who is in the British Government? Who is actually in charge? In the Osborne era, it was the Treasury who took the lead in UK policy towards China, whereas nowadays, the Chinese, especially the political elites, seem to have somehow lost the point of contact in the UK Cabinet Office. So who is really the person we can speak to? The Chinese system is also very complicated, and the British are confused about who to get in touch with in China. But the Chinese have exactly the same Kissinger dilemma: which number to dial?

Gary Campkin: I certainly echo the comments about consistency. These are long-term relationships that need to be developed and worked on. I don't share some of the concerns that have just been expressed about who to go to; I think it is quite clear in Government who is doing what. The last economic and financial dialogue was immensely helpful in moving things on beyond rhetoric and more into an implementation phase, and I think that is what we need to do now. We need to get into implementing how we take the relationship forward in a very practical way.

Q60 **Nadhim Zahawi:** Picking up on that point, there is of course guidance given by the FCO, but what do you think are the main barriers, if I can reframe the question, to trade and investment from China into the UK, and of course from the UK into China?

Gary Campkin: From the perspective of the industry that I represent, a lot of the barriers are non-tariff barriers. They are regulatory, behind the border, and they are about transparency and slowness of procedure, which makes it very frustrating for businesses, because quite often they do not get a quick answer or a quick decision, or a decision that relates to consistency.

There are also specific barriers. For example, in the insurance market, access tends to be granted locality by locality, and we, together with the rest of the Global Services Coalition, which is a broad global coalition of services industries, have been concerned about Chinese proposals to localise IT and encryption keys, which is in effect a form of protectionism. There are issues out there, but I think we're finding ways of addressing them, and the best way to address them is through full and transparent dialogue, and, as I say, it is really important that we work together with the Government to do so.

Stephen Phillips: There is a common theme that companies from both countries find in each other's country, and that is just lack of familiarity with the overall environment, but in many ways, that is the biggest impediment to begin with. We may think there are level playing fields here in the UK, but for Chinese companies it is just awfully complex, just as China is awfully complex to British companies. That should not be underestimated. It is a real skills and education issue, and there is more work that both Governments can do in that area.

Gary Campkin: Can I add one codicil to that, which Stephen reminded me of? We hear a lot from the Chinese financial community here of the problems about getting people in here—the right people at the right time, at the right speed. It is not just uni-direction.

Q61 **Nadhim Zahawi:** Obviously, much of the Chinese economy is still closed to full foreign participation. The $64,000 question is this: do you think there is sufficient political will to improve trade and investment further, and can China's political and intel concerns ever be overcome to such an extent as to allow free trade with foreign countries?

Stephen Phillips: I think that there will be slow and steady progress. In some of the key sectors where the UK wants further market access, particularly financial and professional services, I think we need to recognise that it will be a very hard slog.

Gary Campkin: I agree. It is going to be a long-term process, and it is an option that we just have to continue to pursue.

Q62 **Mike Gapes:** Can I take you back to President Xi's state visit in 2015? At the end of that visit, it was announced that $40 billion of investment was going to result. Did that visit lead to investment and trade that would otherwise not have happened, or was that just a rebadging and a repackaging of what was likely to be happening anyway?

Stephen Phillips: I think it is a little bit of both, in all honesty. I think that the state visit was incredibly successful, and undoubtedly it is opening the pipeline for much more trade and investment. Would some of those deals have happened anyway? Absolutely.

Dr Yu Jie: I think if you look from a political perspective, the entire red carpet treatment from Britain—Xi Jinping is trying to tell his domestic audience that China has been a strong country and Xi Jinping himself is a very strong leader standing on the international stage. We should not ignore the political message behind the state visit. Regarding the investment package, I would argue that it is almost like a teaser to try to get more Chinese investors to come to the UK and London and make further investments. If you look at recent purchases on the property market, 40% of Chinese investments in the UK are made up from the property market, followed by oil and gas, which accounts for 23%, and 8% in the financial services. The state visit is almost like a teaser leading to more Chinese investment coming to the UK.

Q63 **Mike Gapes:** So you are both saying the same thing; these things were happening, but it is also encouraging more investment. Are there any concrete results from those announcements? Has anything come through in any form yet?

Stephen Phillips: We do not track that, but I can go away and find out.

Dr Yu Jie: There are a couple of numbers that I can mention. Between 2014 and 2016, the top 30 well performing Chinese companies in the UK employed 20,000 permanent employees in the UK. If you want numbers regarding local employment, 20,000 is a good number.

Q64 **Mike Gapes:** It was announced around that time that there would be a global, comprehensive strategic partnership between China and the UK. I would be interested to know what that means. As far as you are aware, how many other countries does China have such a partnership with?

Dr Yu Jie: Six countries come to mind that share a global strategic partnership: Russia, the United States, France, Germany and India, as well as the UK. China would signify its great power status to those other countries by calling that partnership a global strategic partnership, just to show how important those partnerships are.

Q65 **Mike Gapes:** So all the members of the Security Council plus India.

Dr Yu Jie: Yes, plus India and Germany.

Q66 **Mike Gapes:** In the past, it has been suggested by some people that trade and investment with China is greatly influenced by the state of political relations with China. The Dalai Lama came to this country and met Prime Minister Cameron in 2012. Did that lead to a reduction in trade or investment, was it unaffected or did it go up?

Dr Yu Jie: Obviously, you have experienced an 18-month frozen period between China and the UK. Political conditions is one of the key co-interests for Chinese foreign policy. Whatever happens, Xi Jinping has to show his stance and take care of such issues. Perhaps it is something that China could improve in the future by considering that trade and investment itself cannot buy respect or project soft power. Perhaps the Chinese leader could learn that in future.

Q67 **Mike Gapes:** I am interested in the actual data. Is there any correlation with something that led to criticism politically, and that publicly the Chinese authorities were not happy about? Was there a corresponding reduction in investment or trade in practice, leaving aside the rhetoric? Sometimes we are told that there will be serious consequences, but it is hard to notice what those are.

Stephen Phillips: In that particular case, trade and investment continued to grow. However, there have been other very similar instances with other countries, where trade investment has been hit very hard, so there are degrees of impact. In that case, the political relationship was on hold—frozen—for a period, whereas the commercial relationship continued to flourish. That would not necessarily hold true in future.

Mike Gapes: I am not asking you to speculate about other cases. This is factually something that has happened, so we have data. Thank you.

Q68 **Chair:** Can I turn now to the relationship at the political and administrative level between Britain and China? How would you assess the so-called Osborne doctrine? You referred to the Osborne era, Dr Yu Jie, and his time as Chancellor. Do you think the Chinese have perceived a change since George Osborne stopped being Chancellor of the Exchequer? If so, are they right to do so?

Dr Yu Jie: Obviously, the Chinese extremely welcomed the Osborne doctrine. They used to consider Osborne the go-to person in the UK, but nowadays that seems to have lost validity.

The Chinese are now very perplexed, thinking, first, "Who is the person we can look to in the UK Cabinet Office?" Secondly, they think, "How much investment would it be really worthwhile to invest in the UK if, for example, the current Government do not care about China anymore?" The British Government keep sending a confused message to the Chinese Government about exactly how Britain values China.

Q69 **Chair:** Perhaps you could answer that question yourselves. Where do you think the lead now sits, if you think the Chinese are confused and you are trying to unconfuse them? Or are you confused yourselves?

Stephen Phillips: I think the high-level language remains the same on both sides, using golden era language. I think the tempo of engagement between the two sides has decreased somewhat, but people pragmatically see that, with Brexit and the US elections, there have been other things diverting the political system here. People have taken a little bit of a wait-and-see attitude. Obviously, there is an expectation that the PM will visit China this year and that the UK will attend President Xi's Belt and Road summit in May. That will be interpreted on whether it is sending positive or less than positive signals.

Dr Yu Jie: Another thing I could add is the nature of US-China relations. Don't forget that during the Osborne era, Osborne unilaterally decided to go alone and join the AIIB and that annoyed the American allies in Washington DC enormously. It would largely depend on the nature of China-US relations where the UK has decided which side to side together with, either with the traditional ally or with the economic partner. That is really a choice for the British Government on which side to stand at the end of the day. There will also be so many unexpected twists and turns in the China-US relations.

On the other hand, don't forget, Trump is a more Atlanticist American President compared with Obama, who was a more Pacific President. To that extent, Trump would be closer to the traditional ally, whereas Obama seemed to rely more on an Asian partner. We should not forget the American factor in the China-UK relations. What happened with AIIB was only a foretaste of the world we have coming up.

Gary Campkin: May I add two thoughts, Chairman? To go back to what I said earlier, the key in many ways is to move from rhetoric into implementation and some real momentum. The sense coming out of my industry's perspective of the November 2016 economic and financial dialogue was extremely positive. If the Committee refers to the documentation coming from that group—the policy outcomes paper—there is a significant chunk of stuff that was agreed in there that is extremely positive and is about really taking things forward in a key range of interests for the industry.

The second thing I would say is to confirm Stephen's hope that we will have some very high-level visits to China very shortly. They are important for taking the relationship we were talking about earlier forward in a positive way with new dynamics. My sense is that things are where they need to be, but as with any relationship one needs to continue to work at it.

My last comment on this area is that I understand that the Department for International Trade has already embarked on some very positive discussions with the Chinese authorities about the relationship post-Brexit, so I think there are some very good things to point to.

Stephen Phillips: May I endorse Gary's comments about the last economic and financial dialogue? There was palpable progress there, particularly around reciprocity, where perhaps the UK has not leveraged its position as well as it could in the past. That was really noticeable in the communiqué.

Q70 **Chair:** How well do our senior Departments currently co-ordinate their approach to China on trade and investment—indeed, what about the less senior Departments in the Government? From memory, I think the Education Secretary and the Culture Secretary recently went on a visit to China. Are the Chinese able to disaggregate? Is that work opposite number to opposite number, even if its education and culture, alongside the more senior relationships of Prime Minister, Foreign Secretary, Trade Secretary and the Chancellor?

Stephen Phillips: My impression is that it is actually working quite well. It really goes to the heart of this comprehensive strategic partnership. We have the economic and financial dialogue, the Prime Minister, the ministerial summits, the trade talks and the people-to-people dialogue. There are lots of mechanisms in place where the right Ministers slot into place, and I think it is working tremendously well. It is very exciting when you participate in those events. There is a real buzz around the conversations taking place.

Q71 **Chair:** Dr Jie, you seem to suggest that there is some confusion in the Chinese mind about who to engage with—let alone us wondering where the priorities sit in the United Kingdom and who is in the lead. It was clearly the Chancellor until Brexit.

Dr Yu Jie: May I speak not just about the economic and financial dialogue, but bring up the strategy dialogue that took place in December last year? The Chinese State Councillor, Yang Jiechi, who is probably the most senior person in Chinese foreign policy, came to the UK and has already started to talk about exploring the possibility of having a bilateral free-trade agreement between China and the UK. The senior officials from the Foreign Office seemed to look very perplexed and lacked interest, so the Chinese feel that they are somehow being left behind on this.

Q72 **Chair:** But surely they should have been talking to Dr Fox's Department. It may lack capacity, but I rather doubt it lacks interest.

Dr Yu Jie: As far as I understand from the Chinese side, they felt they had been left behind by this, regarding the bilateral free-trade agreement. That is the first point I would like to bring up.

Secondly, the Chinese always feel very confused about exactly who the British Foreign Office represents. Does it really represent party politics, or does it represent the Government? Don't forget that the Chinese still don't quite understand that there is a division between the party and the Government, whereas China is a party state and obviously the two merge together.

May I add a few more elements? The Chinese Foreign Secretary and the British Foreign Secretary are not on the same ranking at all. The British Foreign Secretary is the No. 3 or No. 4 in the Cabinet, whereas the Chinese Foreign Secretary ranks probably around 36 or 37 within the party. That tells you the significance.

Q73 **Chair:** Right. On your assessment of our Government's expertise, experience and capacity to manage this relationship, what is your view of whether as a country we are good enough, committed enough and capable enough to do justice to this relationship? Mr Campkin, why don't you start? Your candour would be much appreciated.

Gary Campkin: The best way I can answer the question is to say that as we move towards tomorrow and the triggering of article 50, there are challenges and opportunities. Certainly, if one looks at the opportunities, one of the things that this country is going to have to look at embracing is its international relationships, and in a different way from how it has done to date. My own view is that the Foreign and Commonwealth Office, the Department for International Trade and the Department for Exiting the European Union are working very closely on their respective leads, obviously together with the Treasury, which is the sponsor Department for financial services. So from our perspective we have absolutely no problems with the way they are addressing the issues.

The key thing is that areas like an independent UK trade and investment policy will have to be put in place for the first time in a generation. That will require some deep thinking—that is going on—some skilling-up and some staffing-up within the Department for International Trade. We believe that the Foreign Office's overseas network is a real national asset. Again, it is incredibly important to make sure that the overseas network is properly resourced to do the things it needs to do and that other Government Departments have effective representation in post in major destinations like China. Everything that I have seen to date suggests that the issues are known, that the scoping is going on and that people are very engaged in both addressing the challenges and looking at the opportunities. Certainly from TheCityUK's perspective, we are working very closely with Government to address both of those areas.

Stephen Phillips: On the whole, there is a lot of very good work going on. If I highlight the exceptional end of the spectrum, the FCO's outreach team is doing phenomenal work across Chinese provinces and regional cities—

Q74 **Chair:** Better than others, like the Germans?

Stephen Phillips: Yes. That is genuinely globally leading in terms of the approach that is being undertaken.

At the other end of the spectrum, on trade and investment I think we are too focused on short-term targets and not focused enough on the medium term and long term and really positioning the UK for the future. Part of that, I think, is that not enough work is currently being done on market access—although the balance is shifting—and perhaps Government are trying to do too much business development on behalf of business when their resources should be more focused on pushing down these barriers: tariff less so, and non-tariff more so.

Dr Yu Jie: Just to give you some numbers, at the moment in the British embassy in Beijing there are about 500 employees dealing with all the China issues across climate change, finance, human rights and various other sectors. From the number level, they are doing an extremely good thing. On the other hand, I have to say that the sense of a lack of understanding of the Chinese political system somehow hinders certain British diplomats in trying to understand the system. Perhaps there is room for improvement there for the British diplomats working in Beijing and across China.

Gary Campkin: May I make one other comment, which I think is particularly relevant to the Committee? That is the use of the UK's multilateral posts. The bilateral relationship is actually not just a bilateral relationship; it is about working through the multilateral posts in Geneva, New York and elsewhere to make sure that the relationships and interactions that the ambassadors and heads of mission have there with their counterparts from China play into that broader relationship dynamic.

Stephen Phillips: I actually think that is really important. Too much Government thinking is bilateral, and because some of these commercial opportunities are in third countries now, a much more multilateral approach to the relationship would be commercially beneficial.

Q75 **Chair:** Will the United Kingdom be able to triangulate the relationship between China and the United States, and outside the European Union perhaps have a distinctive positon to take with China that would be of benefit to us and indeed to China?

Stephen Phillips: I suppose in many ways that is the million dollar question. President Xi is expected to visit the US in a few days' time, and perhaps then we will have rather more clarity over where some of the pieces of that jigsaw are going to fall. I think it is too early to tell, in all honesty, but it will be complex. There are issues where the UK, China and the US are aligned—North Korea, for instance, which is a very complex geopolitical issue where there is clear alignment of interest.

Gary Campkin: My only comment is that the UK's national interest has never, ever been a question of either/or. That has always been a false choice. The UK's national interest is actually and/and. If you look at the complexities of our international footprint, that is where the UK tends to prosper. It is looking at those complexities of relationships—where the UK can add value and use its particular points of leverage, wherever they happen to be, to maximum advantage—which will make the difference.

Dr Yu Jie: I share your view. Obviously, the US and China have geopolitical conflicts, whereas the UK and China do not have such conflicts. We should not forget that the UK and China are very good partners in the UN Security Council on North Korea and several other issues. So this other angle is perhaps for the UK to collaborate with China beyond economic and financial dialogues. These are areas that the UK could further explore with China in future. In considering what has happened with One Belt, One Road, a key area is central Asia. China has paid enormous attention to what exactly the British do in the central Asia region. If the UK wants to get into the Belt and Road initiative, perhaps central Asia is potentially an area where the UK and China could co-operate.

Q76 **Chair:** Finally, on Hong Kong's importance in the British-Chinese economic relationship, is China content with the British-Hong Kong economic relationship, and how important is Hong Kong as part of our relationship with China economically? Two questions there to finish with.

Stephen Phillips: May I just explain that I will shortly be moving to a role with Hong Kong Government, so if you do not mind I will not offer a view?

Dr Yu Jie: I do not have any particular comments on UK, Hong Kong and China. One thing that I should perhaps say here is that the Chinese Government should learn how to cultivate a good relationship with the younger generation in Hong Kong. That is probably the biggest headache they will be facing in the next few years.

Gary Campkin: From my perspective, Hong Kong remains important as a gateway to China. Of course it is an international financial centre in and of itself, in its own right, so the linkages between London and Hong Kong in my industry are very strong and will remain very strong in the future. I will posit a view that maybe because of the attention given to mainland China in recent years, Hong Kong might have been slightly overlooked in the mix. We must ensure that, moving forward, we continue to use and develop those links, not just in terms of the direct Hong Kong-UK relationship, but with Hong Kong as part of China in a post-Brexit world.

Q77 **Chair:** So is there no sensitivity that parallels the sensitivity about a perceived political interest by the United Kingdom in the affairs of Hong Kong? Is there no parallel sensitivity about the UK in the economic terms of UK commerce continuing to have very strong links with Hong Kong—will that run into any kind of difficulty in China?

Gary Campkin: I have not been aware of any significant concerns raised, certainly in my industry.

Q78 **Chair:** Is there no Chinese sense that they want to dilute the British economic and commercial interest in Hong Kong in order to accelerate its end state as a normal Chinese city?

Gary Campkin: I have seen no evidence of that.

Stephen Phillips: I would say it is seen as positive.

Chair: On that note, let us conclude. Thank you very much indeed for your evidence, and your time this afternoon, particularly you, Mr Phillips—very good luck with your future role.