HOUSE OF LORDS

Select Committee on International Relations

Corrected oral evidence: UK Foreign Policy in Changed World Conditions

Wednesday 21 March 2018

10.45 am

Watch the meeting

Members present: Lord Howell of Guildford (The Chairman); Lord Balfe; Baroness Coussins; Lord Grocott; Lord Hannay of Chiswick; Baroness Helic; Baroness Hilton of Eggardon; Lord Jopling; Lord Purvis of Tweed; Lord Reid of Cardowan; Baroness Smith of Newnham; Lord Wood of Anfield.

Evidence Session No. 9 Heard in Public Questions 77 - 88

Witnesses

I: Carrie Gracie, broadcaster and former China Editor, BBC; Professor Steve Tsang, Director, China Institute, School of Oriental and African Studies, University of London.

II: Stephen King, Senior Economic Adviser, HSBC; George Magnus, Former Chief Economist, UBS; Stefania Palma, Asia Editor, *The Banker*.

USE OF THE TRANSCRIPT

1. This is a corrected transcript of evidence taken in public and webcast on www.parliamentlive.tv.

Examination of witnesses

Carrie Gracie and Professor Steve Tsang.

Q77 **The Chairman:** Professor Tsang, good morning and thank you for being with us. We are expecting Carrie Gracie from the BBC. She is on her way, but we thought we would start anyway. The temperature in this room ranges from freezing to boiling, so if you need to take off your coat or relax, please feel ready to do so.

All of this is on the record. There will be a transcript afterwards, which you will be free to change or adapt, as you wish. As usual, anyone on the Committee with interests should mention them at the beginning of their questioning.

The Committee is looking at the UK's foreign policy posture, implementation and methodology in a vastly changed world, dominated by digital technology and the web, with interconnection on a scale never before known in history. To do that, we need some appraisal of the nature of that changed world, although we cannot cover everything.

What has changed? One of the biggest things that has clearly changed over the last 20 years is the enormous rise of China's influence and power in the world economy and the whole geopolitical situation. We seek your wisdom to give us some assessment of how big that change is. My first question is an obvious one. To what extent do you think that President Xi Jinping has changed China and its international role compared with the Hu Jintao era and previous years? The answer to that question is in a sense obvious; he has changed it enormously, so could you add to that? What do you think are the main drivers that have brought about this fantastic transformation?

Professor Steve Tsang: Thank you very much, Lord Chairman. As you said, the changes are significant.

The Chairman: Perhaps you would pause for a moment, because our second guest has arrived.

Carrie Gracie: My Lord, I apologise; I am so sorry.

The Chairman: Your apology is completely accepted. It is becoming harder and harder to get into this Palace anyway. I have just said to Professor Tsang that it is very warm in here. I apologise for that. Usually, it is very cold; today, it is very warm. I also said, as I am obliged to, that the whole session is on the record. A transcript will be made, which you can change if you wish.

I was just putting to Professor Tsang an opening question about the extent of the change under Xi Jinping from past Chinese leaders, and adding my own answer, which is that obviously the change is enormous. What are the drivers, in your view, impelling China to such a colossal position in world economic, security and geopolitical affairs? It is a fairly general opening question. Professor Tsang has just started. Please continue.

Professor Steve Tsang: Significant changes are clearly taking place, but I do not think they are a fundamental departure from the general patterns in which China was going to be moving anyway. If we go back to the start of the post-Mao period, when Deng Xiaoping laid down new foreign policy guidelines for China, they were about keeping a low profile and biding time. The implication was always that, when the moment came and China was ready, it would claim its place in the sun. There never was a realistic prospect that, if and when China became rich and powerful, it would continue to take the same approach as it took in the Deng Xiaoping era when it was keeping a low profile and not doing very much.

The big difference is that Xi Jinping himself is making a different assessment of whether China has reached the moment when it no longer needs to hide its capabilities and bide its time. That change had already started when the global financial crisis hit the world. Belief in the early post-Cold War period was that western democracies and capitalist systems were doing fantastically well, but the hubris of the end of history was proved bankrupt by the global financial crisis.

The Chinese Government felt that the way they managed the economy and the general situation in the aftermath of the global financial crisis proved that China could do better than the western countries. That gave China confidence, even at the tail end of the Hu Jintao era. Xi Jinping is much more open, saying basically that now China requests and requires the rest of the world to pay it due respect. China is playing a much more assertive role in global affairs and in its region.

The Chairman: Carrie Gracie, a point has been reached; China has an assertive role. What is your estimate?

Carrie Gracie: I echo what Steve said. China obviously lives within the context of everybody else, despite being as huge and inward-looking as it is in some respects, and being so exceptional in its version of itself. Steve has referenced the context in which it has lived over the past 20 years, but it is worth dwelling for a moment on the fact that the collapse of the Soviet Union in the early 1990s was a hugely important moment for all Chinese communist leaders, particularly Xi Jinping. You are probably aware that Xi Jinping is reported to have said that the reason why the Soviet Union and its Communist Party fell apart was that no one was man enough to stand up for them. He is the self-declared man standing up for Chinese communism in a way that is obviously wrapped in the Chinese national flag, because there is increasingly not a wafer of space between the party's definition of itself and its definition of the state.

The collapse of the Soviet Union was enormously important, in a historical context, for where China decided to go in the past 25 years. The other hugely important motivating factor in the drive towards greater centralisation under party control was the Arab spring. Both of those have been in the party's thinking about how it regards itself and its role in governing society, and a source of strength and conviction for its propaganda or messaging, depending on how you want to describe it. It feels that the collapse of the Soviet Union and what came afterwards in Russia was a terrible mistake and set Russia back. It feels that the Arab spring was a failure. It has used that messaging to its own public. At the same time, events in the West and in western foreign policy have provided a strong motive for centralising top-down party control politically, in the party's mind.

An opportunity has also been provided by the perception of the party, and other forces within Chinese society, of the failures of western liberal democracy both at home and abroad: for example, Brexit, or the conduct of the American presidential election in 2016, with language such as "Lock her up", and the descent of the debate into what Chinese public figures would regard as an undignified spat, which they made full use of internally, and, in their view, a failure to address serious policy issues. At the same time, there is the outcome of the election, and the ways in which the United States has moved since then on the world stage: withdrawal from the Trans-Pacific Partnership Agreement and withdrawal from the Paris climate change accord. All of those have provided opportunities for China to present itself, both inside and abroad, as politics that works pragmatically. That is the Chinese view of events.

In his five years in office, Xi Jinping has attempted to convince significant portions of the Chinese public, with a measure of success, that he is doing a good job on anti-corruption and cleaning up public service; that he is a doing a good job and intends to do an even better one with the greater power he has accrued to himself in tackling vested interests in the economy; that he is attempting to get on top of the environmental problems of China; and that he is attempting in a more serious way than any other Chinese leader in the past three decades to get on top of inequality and poverty, so that there is not just a competent Chinese party state but one that takes all its citizens with it. It is hard to determine the measure of success, because we do not have effective polling of the Chinese public; I base this on my anecdotal experience travelling around China.

The Chairman: What kind of place in the sun is it going to be? President Xi was talking in fairly big terms yesterday about China's world ambitions. Are we talking about more assertion of territorial rights in the South China Sea? I see in the Xinhua News Agency this morning that President Xi had a long talk with President Modi about a new partnership with India. Where do the Chinese stand in their relations with Russia, which seem to be going from hot to cold to hot again? What is the place in the sun? Is it aggressive and expansive or is it peace loving? Can you give us a feel about that?

Professor Steve Tsang: It has never been spelt out exactly what the rightful place for China would be in the international world. Xi Jinping talked about the rejuvenation of the Chinese nation. That is basically what he said. We have to try to reconstruct from his language what he actually meant by rejuvenation of the Chinese nation. We are talking about 2,000 years of history. They claim 5,000 years, but we are really going back 2,000 years when the first empire was created in about 220 BC.

When the Chinese Government or the Chinese Communist Party talk about restoring China to its previous periods of glory, they are referring mostly to the last imperial dynasty, the Qing or Manchu dynasty. If we look at historical maps of China, the Manchu empire was the largest one, and nearly two times of the territories of China proper were added in the Manchu period. That is what the Republic considers the rightful size of China.

That poses a problem for its neighbours, because in the Chinese reconstruction of China's historical relationship with its neighbours China was always benevolent; it was never imperialist by definition, because only western powers could be imperialist, including the Japanese. The Chinese by definition could never be imperialist, even though they actually had an empire. If the peripheral countries of China were all paying homage to the imperial Government in Beijing, it was a fantastic symbiotic relationship; there was no need for China to use force outside its territory because its neighbours were all paying homage to the emperor, who was supposed to be the son of heaven.

We do not know whether that is the image Xi Jinping has. He has never actually said that, but it is probably the most realistic reconstruction. We can see why, from the perspective of President Xi, whatever China does will be beneficial to the rest of the world, and cannot possibly be expansionist. The belt and road initiative, particularly the silk road economic belt to central Asia into western Asia, and from there to north Africa and Europe, is building infrastructures in what was formerly the Soviet Union's backyard; it was part of the former Soviet Union that is now Russia's backyard. That perhaps explains why the Russians are not as enthusiastic in co-operating with their Chinese partners, with whom they are supposed to have a strategic relationship, as one would expect them to be.

There is a vast territory in the Russian Far East that used to be part of the Qing Manchu empire and was ceded by the Qing Government to imperial Russia in 1860, after imperial Russia brokered a peace between the UK and France on one side and China, the imperial Qing Government, on the other side, after the so-called second opium war. The Russians occupied all that territory, and the Chinese have never forgotten. The Russians are aware that the Chinese have not forgotten, but the Chinese have not raised it as an issue. There are issues between the two countries that they are concerned about.

China's neighbours, whether we are talking about north-east Asia, south-east Asia or India, are all in some way somewhat uncomfortable, partly because of the existence of territorial or maritime disputes and partly because of history. For example, Vietnam had a history of being conquered by the Government in control of China, from the second empire onwards—the Han empire—from about 200 BC, and of the Chinese being pushed back from Indo-China by Vietnamese Governments at different time in history. There are long-standing concerns about whether the Chinese have more ambitions over their territory. Other countries are aware of that. India has a major territorial dispute with China in the province of Arunachal Pradesh, which the Chinese call southern Tibet. Because China now exercises sovereignty over Tibet, the Chinese view is that that they should enjoy sovereignty over southern Tibet as well.

Those problems will not go away. From the Chinese Government's perspective, China is always benevolent. If any of its neighbours are having problems, it is other people who are having problems, not China.

The Chairman: Is there anything you would like to add?

Carrie Gracie: There is nothing Steve said that I would disagree with. That internal and external presentation as benevolent is very important. The other side of it is a victim psychology, which is extremely significant in China and must be understood by people. Young Chinese are taught from a very early age that for two centuries they were the victims of terrible humiliation at the hands of foreigners, beginning with the UK. It then becomes very difficult for the Chinese, given their education and the increasingly single-minded mainstream messaging where there are no competing versions of reality. That messaging is very powerful in current or future situations. In relation to Hong Kong, Taiwan, the South China Sea, the East China Sea, Tibet, Xinjiang—you name it—wherever other people try to assert an alternative reality, or even a competing one, it is unacceptable. Those people are either misguided or deliberately making mischief; the definition will depend on what the state sees as the appropriate message at the time.

The victim psychology is very important. It makes it uncomfortable for China's neighbours, obviously. They have been there for a long time, so they know the game as it is played living next to China. To take a recent example, South Korea has had a difficult past couple of years given the deployment of THAAD weapon systems, which China is extremely exercised about. There were very serious but unofficial punitive trade sanctions against South Korea, and not just trade sanctions. South Korean supermarkets in China found their businesses falling off a cliff; the sales of everything fell off a cliff. Musicians were not allowed to go to China. The extent of the damage to South Korean business in China as a result of the move to deploy THAAD was very significant. The Chinese are coming back from that now, but those sticks and carrots are always available in the armoury. That is an experience all China's neighbours know.

Looking at the five years we have had of Xi Jinping and the way he has consolidated his power, lifted term limits and made it clear he will go on longer, if you are in Hong Kong, Taiwan, Tibet or Xinjiang and you want to assert an alternative reality, you are looking at a very grim time ahead.

Lord Reid of Cardowan: I am interested in exploring a comment you made about the influence of events in what was the Soviet Union and afterwards on Chinese leadership thinking. The Chinese, to put it very simply, are trying to achieve a balance between the political monopoly of the Communist Party in a vanguard role and introducing dynamism and choice at the economic base in a controlled fashion. That is not an easy thing to do, particularly when their own philosophical background would lead them to believe that ultimately the economic base, where they are introducing choice, will determine the future of the political superstructure.

In a sense, one assumes that Mikhail Gorbachev, with glasnost and perestroika, was trying to introduce something crudely similar to what Deng Xiaoping was doing. That failed, resulting pretty much in economic chaos, gangsterism and the primitive accumulation of capital in Russia. Is that the way the Chinese see it? Do they blame that on getting the balance wrong and lack of control of the political monopoly? If so, what does it say about their future tendency as regards that balance? Does that make sense?

Professor Steve Tsang: It makes perfectly good sense. It is something that the Chinese Communist Party was very much aware of all the way back to the 1980s. They believed they had perfected the art of dealing with it by the 1990s. They had a term for it: the bird-cage theory. It is not so much a matter of the Chinese trying to balance political control and economic freedom; it is a matter of putting economic freedom in a political framework that will enable the party state to keep control and yet allow scope for the economy to be sufficiently free and vibrant to avoid the fate of the Soviet Union.

The idea, essentially, is that the economy is like a bird and the party is the hand. If the hand holds the bird too tightly, the bird dies; if the hand releases the bird, it flies away and disappears. Therefore, you put the bird in a bird cage and, as necessary, you enlarge the bird cage, which was what happened during most of the reform period from the time of Deng Xiaoping until quite recently. The bird cage got bigger and bigger, to the extent that we often did not realise that it existed. Because there was so much freedom for the economy, we thought the bird cage had disappeared, but it has never disappeared.

The approach we are now seeing under Xi Jinping is not to keep enlarging the bird cage, being prepared to reduce it as necessary. Now you design a smart bird cage, so that bits of it can be enlarged and other bits can be reduced, to have more effective control over the economy where the party wants it, allowing the economy to continue to have more space to operate where it is not likely to pose any threat to the Communist Party's continuation in power in China, if that makes sense.

Carrie Gracie: If I understand you correctly, Lord Reid, you said that China wants to avoid the gangsterism that followed the break-up of the Soviet Union. China has had that. China has had a very high degree of gangsterism among its political elite. It is just that it is quite good at hiding it until the ruling Communist Party boss at the time decides to expose a gangster, called tigers in Xi Jinping's language, and name and shame to scare the others. At the same time, it has employed the bird cage. The bird cage has been there, and the gangsters have been thriving in it. In a way, the argument that appeals to many Chinese is that the reason they need strong centralised Xi Jinping rule, which goes on and on and has no term limit, is precisely that their economy was becoming a victim in an uncontrollable fashion to gangster bosses in the Communist Party.

I was interested in your reference to the superstructure and the kind of Marxist thinking that you might imagine would drive the thought processes or intellectual universe of a Chinese Communist party leader. Xi Jinping has made it very clear that that is not what drives him. What drives him is a deep sense of Chinese history. It is quite original among Chinese leaders to have the confidence to come out and say, "Do you know what? What is this Marxism?" Obviously, he would not say that openly; it would be too confrontational. If you look at his speeches, he is very well versed in Marxist theory and has studied it, but when he is talking to the Chinese public he goes back to history for his references, metaphors and examples in a way that previous Communist Party leaders have not done.

From 1949 until Xi Jinping, that history was still off limits because it was feudal. China needed to get away from that history. Now Xi Jinping is bringing it back as a legitimising force for the Communist Party. Basically, his argument is the bird cage. China is a huge and complex country; it cannot function, and it cannot be great or rejuvenated or take its rightful place in the sun without strong leadership, almost on the imperial model. He probably would not admit to it, but it is almost as though he is clothing himself in the benign emperor model.

Obviously, the Chinese have great economic challenges ahead because they are a middle-income country. They have a mess created by the filthy 19th-century industrial revolution that they conducted at high speed in the late 20th and early 21st century. They have an increasingly affluent, well-informed and well-travelled public, who do not want to live in a polluted toxic wasteland. They have to clean all of that up and transition from the old model economy to the sunny green uplands of a 21st-century innovative economy. Xi Jinping's message is, "I will do that if you give me the power. I am the man to do it". I think he has convinced a lot of people.

The smartness is very interesting. If you had Xi Jinping here and said, "Hang on. Surely, under Chairman Mao the feedback loops were disastrous. The truth was never delivered and horrible mistakes were made. Millions died in the Great Leap Forward, and there was the chaos of the cultural revolution", he might say, "Well, I have the smart 21st-century model where we have big data, artificial intelligence and a fabulous surveillance system, and we can judge the public mood in a really clever way". He would not call it managed democracy in the way people might talk about Russia; it is a kind of consultative model where you take the temperature of the public. The Communist Party spends a lot of money and time assessing the mood of the Chinese public; it is very careful to assess the public mood. The smart bird cage is a very meaningful effort by China to deal with monopoly politics in the 21st century.

The idea that the birds in the cage can be free if they are not coloured Communist Party red is questionable. At the same time as he is doing these things, Xi Jinping is driving Communist Party cells in all parts of Chinese society, in academia and business. Even Disneyland has a Communist Party cell. Everybody has to come out and say how wonderful it is to have a Communist Party cell in their business. Perhaps in some ways it is. I am not disputing it. All I am saying is that people in Chinese businesses tell me that, if you have a Chinese Communist Party cell in your business, it soon becomes apparent who is giving the instructions. The idea is that the birds are flying around in a market economy and the cage is just on the outside; the cage is right in there and it is operating the individual.

Q78 **Lord Grocott:** This is another aspect of the seismic effect, as I think you described it, of the end of communist rule in the Soviet Union. To what extent is China's reaction due to the fact not just that the Communist Party is no longer in control but that there was a huge geographic change in the Soviet Union as a result of that period? Large swathes of what was Soviet Union territory no longer are, and there are strong national groupings within what was the Soviet Union. We all know a bit about Tibet and those aspects of life in China, but to what extent is fear of national groups within the empire a factor, and is it a realistic concern?

Professor Steve Tsang: We have to make a distinction between ethnic groups in China that are causing problems and what the party sees as them causing a problem. They are not the same thing. We do not see much threat to the Chinese Government or to China as a whole. There is no independence movement in Tibet. The Dalai Lama does not ask for independence; he just asks for ~~a~~ genuine autonomy within Tibet. Even in the Xinjiang area, the Muslim population, usually called the Uyghurs, are historically mainly a tribal set of communities. The Uyghur identity became a much more modern identity under Communist Party rule, because they were being collectively treated in a fairly similar way and therefore they developed a "them and us" identity in a classic sense.

Until quite recently there has been very little independent evidence of the Uyghurs posing a terrorist threat to the Chinese state or Chinese society, but the Chinese Government treat them as if they were terrorists. Because of that treatment we have seen desperate acts by some of those people—for example, the knife attack at Kunming railway station. A group of about a dozen people tried to get out of China through south-east Asia countries. When they were blocked and had no way of leaving China, they faced the prospect of going back to Xinjiang, or wherever they had been living in China, and being caught by public security at some stage. They knew, or they thought they knew, what their fate would be if they were ever caught, so, faced with the option of a life not worth living and going out with a big bang, they chose the latter. I am not trying to justify what they did, but the sorts of actions that are now being described as classic Uyghur terrorist attacks are much more the result of government policy.

The Chinese Government were very concerned when the Soviet Union collapsed. What they were seeing was not only the collapse of the Soviet Union but basically the collapse of the whole of eastern Europe. I cannot know for sure because I was not one of them and certainly did not speak to them, and even if I had they would not have told me, but that was probably the moment when some of the top leaders, who had made the decision to conduct a military crackdown in Tiananmen Square in the spring of 1989, thought it was jolly good that they had done it. The Communist Party in China having done that in the spring of 1989, there was not a squeak in China when the Berlin Wall came down. When the Soviet Union collapsed two years later, everybody in China knew that, if they tried to do the same things as were being done in eastern Europe or the former Soviet Union, the party and the PLA would come out, so nobody did.

The party was aware that it then had a new lease of life, but it was one that it had to make sure it did not squander. There was a very strong sense that, if the leadership did not hang together, they would hang separately, so there was a very strong effort on the part of the party to stay together and to nip in the bud whatever dissent and challenges arose anywhere in China, even the grossly exaggerated response to the Arab spring in Beijing. People were using social media in China to try to organise a walkabout in the middle of Beijing city, by McDonald's in Wangfujing, and suddenly thousands of public security officers were swarming into Beijing, more than the potential demonstrators. They completely squashed it. It worked. The Government's perspective was, "Those foreign journalists wrote about it, laughed at us and poked fun at us, but we did what we had to do to protect the party state". By protecting the party state, they believed that they protected the future of China.

Carrie Gracie: On the disintegration of the Soviet Union, I mentioned earlier Xi Jinping's line about nobody being man enough to stand up. The way that resonates with the Chinese public is, "You don't get to disintegrate our territory". It is hard-wired and visceral: "We lost territory as a result of two centuries of oppression and humiliation". You hear it in every key speech that Xi Jinping makes. The NPC closing speech was about "not one inch of our territory will anyone take". Two issues count: the territorial issue and economic effectiveness. Pragmatically, the question the Chinese public ask is: is it working economically? The other is: is it working to make my nation strong? If the answer to both of those is no, they do not want it, and that is what has happened to the model of liberal democracy as regards the Chinese public.

I cannot stress enough how enormously the Chinese public mood has changed in relation to the approval rating for the idea of liberal democracy. I would have said that in 1991 a lot of the Chinese public, certainly the intelligentsia and educated people in cities, would have felt that China was the next to go; it would have to reform politically and move away from single-party politics, but in the intervening two-and-a-half decades that mood has changed. People do not now admire and envy the politics of this country or the United States.

I should not generalise; I can speak only for those I speak to, but I would say that the number of people who wish for exactly our politics or American politics is much smaller than it was, despite the fact that many Chinese travel to the West. They want the freedoms; it is not that they do not want the freedoms. The issue of social media is very interesting. Whether Xi Jinping's rule, and the way he is centralising and concentrating power in a highly personalised form around himself and the party, is a sign of strength or weakness is a very interesting debate that must be continued. There is a crust of patriarchal party politics on top of a vast seething cauldron of Chinese society full of new ideas, impetus, motivations, relationships, travel and all the rest of it. Those are taking place at social media level. People have their own opinions, but the party is trying to keep the crust on them so that they do not turn into anything that challenges it.

Q79 **Lord Purvis of Tweed:** The evidence so far suggests that what we heard from President Xi Jinping at Davos last year, through the WTO or, more recently, in discussions about the agenda for the G20, about China being a champion of globalisation, free trade and greater liberalisation is more rhetoric. From your evidence, you do not seem to believe that is being reflected in practice, but if President Xi Jinping is positioning China as a supporter of globalisation, are you able to summarise briefly what China's view of globalisation is? Is it the same as ours? Ours is probably more dependent on being part of a multilateral system and a rules-based liberal order. What would China's view of globalisation be, and are we on the same globalisation page as Beijing?

Professor Steve Tsang: If I may be allowed to, I will answer this by comparing globalisation with how we deal with our constitution, even though ours is an unwritten one. We have a constitution, or the Americans have a constitution, that reigns supreme. The Chinese constitution reigns supreme, except that it is under the leadership of the Chinese Communist Party. China takes the same attitude towards globalisation. The Chinese Government are completely, totally and absolutely committed to globalisation as long as it works for the interests and advantage of China. When it does not, that is something to be discussed, negotiated and considered.

We are probably slightly more concerned about how to deal with the constitution as we deal with globalisation. All great powers push for their national interests in globalisation, but ultimately we accept that there are international rules and norms that we have to obey, even if sometimes they do not work in our interests. I think there is a lot less acceptance of that under President Xi Jinping.

The Chairman: We are being asked to believe several impossible things before breakfast. China has accepted globalisation when we know it is full of protection. Can you elaborate?

Carrie Gracie: Obviously, that is true. I agree with Steve. As long as it works for China, globalisation is good, and globalisation has worked for China. Look at the astonishing economic miracle that China has wrought in the past two or three decades of globalisation. Why would the Chinese not want globalisation? It is an absolute triumph for them. As long as it goes on in roughly the same way, with the same rules of the game, as in, "I am China and I am a developing country; I have lots of poor hinterland and, therefore, therefore, therefore", whatever the logic of the different forms of protectionism that China applies—like other countries, it has arguments for different situations—and it works for China, that is great. Now that the US is having second thoughts about various forms of globalisation, it is easy and natural for Xi Jinping to present himself as a leader, as he did at Davos in 2017. Yes, it makes perfect sense. In answer to the question whether the view of globalisation is the same as ours, of course it is not.

Lord Hannay of Chiswick: Am I right in interpreting what both of you have said as being that the idea first adumbrated by a president of the World Bank, previously a deputy secretary of state, that China should become a responsible stakeholder in the global economy is not dead? It is not at all in the same category as our belief that economic prosperity would make them democrats, which looks pretty dead to me, but the other one about China being a responsible stakeholder is still alive, with the reservation that it will look after its own national interest. After all, even when this country says it believes in the rules-based international order, that does not mean that it believes in it when it rules against it.

The Chairman: What about that?

Carrie Gracie: It makes perfect sense. I am not sure I would declare the patient dead on the economic substructure leading to changes in the political superstructure. It is a long game. It is very hard to know what is going to happen in China. If we look back at 2,000 years of Chinese history, we see, as I know Lord Hannay does, that when change happens in the political superstructure in China at an elite level, it can happen very fast and can be very hard to spot in advance. I do not think that is a closed subject, but it is a huge topic.

Going back to globalisation, China is a great trading nation, and of course it must promote globalisation. The Chinese party state is very impressive in its ability to use language to serve its own interests and to appear to mean the same thing as you while not meaning the same thing as you.

Professor Steve Tsang: The Chinese Government do not accept Bob Zoellick's "responsible stakeholder" demand of China. The Chinese Government's view is that China is a very responsible member of the international community and, therefore, it is inappropriate for the Americans to ask China to be a responsible stakeholder to fulfil some kind of American-implied standard. China is fulfilling its own standard of what a responsible stakeholder is and, by definition, it always is.

Q80 **Baroness Coussins:** China's economic involvement and interest globally is often described as being a purely economic interest, with an arm's-length interest in the politics of the place, but we know that spending on diplomacy and soft power has been extremely significant as well. It has been reported that it has doubled in five years—for example, with the establishment of a whole network of Confucius Institutes and other forms of soft power. Could both of you say something about how important soft power and perception are to Beijing? What are China's aims through the use of soft power?

Could you comment on the other side of that coin, given that soft power works both ways? Earlier, you mentioned a decline in interest in and sympathy for liberal democracies, but in the UK, for example, there is a significant and growing number of Chinese children in our independent schools and universities. When they eventually go back to China, do you think they will take with them sympathy for and interest in liberal democracy that might start to undermine what you have described as a decline so far? Perhaps you would comment on looking at soft power as two-way traffic.

Professor Steve Tsang: The Chinese Government do not understand soft power in the way we understand it or Joseph Nye defines it. They completely confuse public diplomacy and propaganda with soft power, but they are very keen on projecting Chinese soft power. The word "project" is used deliberately, because they do not wait for soft power to emanate or emerge; they try to project it, with the capacity of the communist propaganda department co-ordinating and guiding it. The entire network of Confucius Institutes officially comes under an institution called Hanban in the Chinese Government. It is a deputy Minister-level unit, but it is superintended by the propaganda department of the Communist Party. That shows you how it is being managed.

On the effect of Chinese students coming to schools and universities in the UK or other western countries and returning to China, we see a very mixed result. Some of them certainly do show that interest, but increasingly Chinese students no longer do that. It is very different from Chinese students coming here, say, 20 or 30 years ago. They were here in small numbers and they did not have a lot of money, so they had to mix with their British friends or they would get very lonely. Long-distance telephone calls were very expensive. Now they mostly stick together because they are here in large numbers; they are wealthy; they eat at Chinese restaurants; they watch Chinese television; they phone home all the time; they listen to Chinese music; and they even read British electoral news through the Chinese media.

I can share with you my experience with a colleague from China. He got a PhD in political science from a leading American university and was teaching in a Russell group university in the UK for eight or nine years. During the 2015 elections, when we were talking about the Tory Party, he did not know what it was. He knew perfectly well what the Conservative Party was, but he did not know what the Tory Party was, because in the Chinese language the term that is always used is "the Conservative Party", never "the Tory Party". If a political scientist from a leading American university, teaching in a leading British university, still cannot get it, the chance that a majority of Chinese students coming to the UK studying subjects other than political science being able to get what we are in terms of our democratic values is perhaps a bit optimistic.

Carrie Gracie: It is a very interesting area, and one that the UK should be paying a lot of attention to. Xi Jinping says that Chinese abroad should tell China's story well. He has a lot of money to put behind that project, and, as Steve says, the project is taken very seriously. There is no distinction between hard and soft power; it is all part of a spectrum of Chinese influence. As we have seen recently, a number of countries—Australia, New Zealand, Germany and the United States—have been discussing the ways in which influence operations by China in their political and media spheres are becoming a serious issue that they need to engage with and tackle. Australia is the most obvious. If someone wanted a case study where a liberal western democracy was attempting in quite an open way to address the issues posed by growing Chinese influence, Australia would be a good one.

Another very notable thing about Xi Jinping's "Tell China's story well" message is the insistence that ethnic Chinese citizens of those countries should show some loyalty to China. You may think that British citizens of ethnic Chinese descent would be wholeheartedly British citizens, but Xi Jinping thinks that they owe some part of their heart to China. He does not define how he intends to chop up that heart, but he is certainly speaking to those citizens and saying, "You owe some loyalty to China".

Meanwhile, we have seen Chinese influence operations in our universities. Steve is right about all the factors that apply to Chinese students, which is why they will not necessarily go back and promote the idea of liberal democracy. Another important reason is the United Front work through embassy outreach operations by scholar and student associations and so on. Chinese students in this country know perfectly well that they are being watched by the Chinese authorities. They know they are being watched at home and abroad; there is now no distinction. China is very porous; its arm reaches far, and for Chinese citizens the cage is wherever they travel.

The Chairman: We are running hopelessly behind time. It is all so fascinating, and you have so much information for us, but we must press on. Lord Wood, could you be as brief as possible?

Q81 **Lord Wood of Anfield:** I have a question about Chinese confidence in soft power. Do the Chinese leadership now think they pay no price internationally for traditional complaints against China for its human rights record, Tibet and removing presidential term limits? Is there a sense that they have won that battle and that their economic interests in the rest of the world mean that they can be completely cavalier about not being as liberal democratic as we would all want them to be?

Carrie Gracie: Increasingly, but not entirely. To some extent, they sometimes misjudge it because obviously they live in their bubble. We all live in our bubbles. It is probably proper to say that China's bubble is as legitimate as our own thought bubble. The idea that westerners do not really understand Chinese civilisation, language, culture and history is not wrong. They live inside that sphere, and they have a certain framing for the world. They can misjudge the cost of missteps, but they know that there is some cost. Sometimes they do not care, and in some situations possibly they do not need to care, and increasingly they can limit the cost by their economic largesse.

Professor Steve Tsang: Carrie is completely right. I think that most of the time they do not care, but we are in a situation where, increasingly, the few people within the leadership who understand and care are not going to speak out to President Xi. The whole political set-up has been changed since the 19th party congress in October last year. You simply do not contradict what the great president and general secretary wants. If that is what he wants, that is what he gets. You speak against him at peril of your career.

Baroness Helic: You have spoken about soft power but not about grey power, if I can label that as cyber capability, et cetera. How much of that power is China using to find its place in the sun?

Carrie Gracie: China's cyber capability is growing enormously, and at home it is daunting. The myriad indictments against Russian entities for allegedly attempting to meddle in the US presidential election of 2016 would be an impossible narrative in China, because it is impossible for any foreigner to meddle in any way behind the great firewall of China. The most important cyber capability that the Chinese party state wants, it already effectively has, because it is increasingly closed and will possibly become even more so.

Then we come to outward leverage. What is very interesting is the growing clout of China with reference to global cyber capability. Mark Zuckerberg and Tim Cook go on pilgrimage to China in a very conspicuous way. They have their photographs taken with Xi Jinping, but they do not have their photographs taken with an American president. The sense that the party is a very effective gatekeeper for the China market, which is so vast and increasingly rich, means that China can exert influence outwards in cyberspace while maintaining complete control inwards. If we had time, I would introduce a little caveat, but I know we are running short of time.

Professor Steve Tsang: Cyber capability is something the People's Liberation Army takes very seriously. It is a very important element of its capability. It is also something that the Chinese Government see as comprehensive national strength, as they would call it. It is not limited to the capabilities of the PLA; it is the PLA taking the front line, with the support of the rest of the country as the Communist Party requires and requests.

Lord Hannay of Chiswick: Are you saying that the belief in this country that educating international students increases our soft power is an illusion as far as China is concerned?

Professor Steve Tsang: I would not go that far. We should continue to engage with China and welcome Chinese students. Some of them come to understand what we are doing and appreciate it. They also appreciate the opportunities they have when they are here to learn more about their own country that they do not know. Chinese students here and in China ask me about what actually happened in Tiananmen Square in 1989. Those sorts of things are important.

In one case, I was told quite clearly that a Chinese student was a card-carrying member of the Communist Party and how upset that person was when the recent news came out about the lifting of the term of office for the state presidency in China. Students would not have been able to articulate that or share it, or perhaps even discuss it among themselves, if they were in China rather than in the UK or other liberal democracies in the West. I do not think we should give up on them; we should continue to engage with them, but when we engage with China we have to keep our eyes wide open. We have to be aware that the Communist Party of China is not a governing party of China and it is not the ruling party of China. The Communist Party of China owns China.

Carrie Gracie: The only thing I would add to what Steve said about soft power is that British soft power—football, "Blue Planet" and "Sherlock"—is, arguably, more important in debate than students going back, and the broader democratic principles they learn.

The Chairman: We have no time left, but there are three crucial questions on the UK's particular relations with Hong Kong. We will not get through them all. I would like to bring in Lord Reid, Lord Balfe and Lord Grocott. Would Lord Reid like to start, and would Lord Balfe and Lord Grocott come in behind?

Q82 **Lord Reid of Cardowan:** The answer to this question is probably implicit in what you said. Does the British understanding of China—whether government, business or civil society—and Chinese history, culture, structures and so on measure up in any way to today's importance of China in the world and to Britain?

Professor Steve Tsang: We still have some way to go before we reach the point where we understand China as we should. China specialists are still a relatively rare species in this country. We should not really rely on so many China specialists. We need to have a much better general understanding of what China is. We should be encouraging much more research and teaching about China in our universities, to the extent that universities do not want to consider accepting Confucius Institutes. Leading universities do not need them, but there are some that cannot teach Chinese without Confucius Institutes. We know that Confucius Institutes are ultimately managed by the Chinese authorities.

We are putting ourselves in a situation where we are exposing our future generations to the teaching of China that the Chinese Government, the Communist Party, would like to be taught, when we should be promoting understanding of China's history, culture, politics, economy and contemporary situation for what it actually is. When we understand that, things will be a lot easier. When Chinese students come to the UK and can interact with the average person in the street and understand them, they will be much more willing to integrate and learn about what we actually are, rather than going to Chinese studies centres at various universities. Even when they are studying British politics, they go to Chinese studies institutions in universities. There is something fundamentally wrong with that.

Carrie Gracie: I agree. The important thing for all of us is to engage with China in a clear-eyed way. We can do that only if we open our eyes and absorb what we see. We need to be able to understand the visual, aural and other information being presented to our senses from China. I have spent 30 years, on and off, engaged in understanding China, and trying to explain it to British audiences. Sadly, we are still a long way off. To give you a personal insight, it is quite hard even within BBC News to get the China story across effectively. Chinese stories are incredibly difficult to package in a nutshell and peg to a news angle, because there is never a news peg such as a Trump tweet, an explosion in the Middle East or whatever. China is very good at presenting itself as not a news story. That is difficult. We do not seem to have very effectively or coherently found a way to overcome it. I feel in some way responsible for it and can only apologise.

The Chairman: We are going to cover this in the next session, so perhaps Lord Balfe can be very quick, followed by Lord Grocott.

Q83 **Lord Balfe:** We are asked to declare our interests. In the run-up to Chinese independence, together with Commissioner De Clercq, I was the joint chair of the group that liaised between the European Commission and the Hong Kong Government. Then it was very much one country, two systems. China has moved a long way, but the treaty obligations are still there. To what extent has Britain any unique influence left in regard to the integration and development of Hong Kong as a more integrated part of China, which appears to be happening?

Carrie Gracie: It is very difficult, because Beijing makes it clear that it would like the UK to leave it to get on with it, and that it will react badly if the UK sticks its head above the parapet on the subject of Hong Kong. From my conversations with a lot of young people, and from voices in Hong Kong, my sense is that some would like the UK to do more. They would like to feel that the UK could do something useful, but, as we saw in Xi Jinping's speech only in the last few hours, the mood is very robust. I do not think that is likely to happen in a very vocal way. I am not sure that, even if it did, it would have a constructive impact. I am not sure. It is very difficult.

Professor Steve Tsang: I agree that it is a very difficult situation, and the Chinese reactions are pretty much predictable as Carrie mentioned, but we also need to bear in mind that we have an obligation to Hong Kong through the Sino-British agreement. That undertaking is not just a moral duty to the people of Hong Kong; we have made a pledge and we will be judged by whether we fulfil it. We will be judged not only by whether we fulfil it but by whether we even seriously attempt to fulfil it. We need to engage with our partners in the international community, and in North America and in Europe as a whole, to have a much more co-ordinated approach to make sure that the promise of one country, two systems and a high degree of autonomy in Hong Kong can be kept for as long as possible, certainly until our obligations finish in 2047.

Carrie Gracie: In general, I think the Government are engaging with China in a clear-eyed way, as indeed are companies, academic institutions and news organisations. My experience is just one experience, but I feel that it is very important to speak up for one's values, assert where one's red lines are and be firm about adhering to them, because one's Chinese counterpart expects that. They know you will do that; there is predictability in the assertion of your values.

I watch how the German Government operate in relation to China. They are very closely engaged. Angela Merkel goes often, but she always picks a subject to state her values. She always picks something to state her values about. The argument that everything must be done behind closed doors, otherwise you will offend your host or it will be unconstructive, is an interesting observation, given that not all Governments play it the same way.

I agree with Steve about coherent community presentation. I always wondered why European Governments, including the British Government, did not have a Dalai Lama day in Brussels because, if everybody met the Dalai Lama together, no individual Government could be picked off and punished for its leader meeting the Dalai Lama. An attempt to present a united front on issues where otherwise Beijing, given its scale and behaviour, will try to divide and rule is something to think about.

Q84 **Lord Grocott:** This issue has been touched on several times but it is quite an important question. It may even have a yes or no answer. The widespread assumption in the West has been that as China became richer and more global in its outlook, with people moving from one country to another and visiting other countries, it would almost inexorably become less autocratic and more democratic. Is that notion now dead and buried, or not?

Carrie Gracie: We should wait and see. It looks pretty dead and buried right now, as Lord Hannay said earlier, but history can change on a dime in China. I once used the example of frozen waterfalls in Arctic climes. Little mammals trot back and forth across the ice thinking it is entirely solid, and suddenly, one day in spring, the ice cracks in a moment and everything comes down all at once. That is how Chinese politics changes. People should always have a plan B in relation to China. All Chinese citizens have a plan B. Foreign Governments should have a plan B, including the British Government.

Professor Steve Tsang: This is the one area where I disagree with Carrie in this testimony. The Chinese political system is what I call a consultative Leninist system. The most important characteristic of the system is that it is anti-democratic, not undemocratic. As long as the Communist Party is in power, it will not allow democratisation to happen.

Carrie Gracie: I entirely agree. My point was that there may come a day when it happens. We just do not know, but we would have to say that for the foreseeable future Xi Jinping is it.

The Chairman: Sadly, that is where it ends. We would like hours more with you because it is fascinating. Carrie Gracie, you have been marvellous at conveying China to a British audience over the years. Thank you very much. Professor Tsang, your wisdom is much appreciated. Maybe the ice will break. Who knows what happens next—whether in China or anywhere else in the world, for that matter? Thank you very much indeed. You have been very patient with all our questions.

Examination of witnesses

Stephen King, George Magnus and Stefania Palma.

Q85 **The Chairman:** Thank you for coming and sincere apologies for the delay. We are dealing with a giant subject and it is very difficult to know where to draw the lines and parameters. Formally, I should say that this is an open public session and everything is recorded. A transcript is available afterwards, which you can of course correct if you wish. Members of the Committee are obliged to declare any particular interests when they ask questions.

To set the broad scene, the Committee is looking at the impact of technological turmoil and revolutions across the world and the way in which they affect British foreign policy, its implementation, its equipment, its formulation and so on. To do that, we need you to share your expert views on what is happening in that wider world, to what extent it is driven by technological revolution and how we begin to cope with it. That is our large canvas. In this session, we would like to concentrate on the economic and financial aspects. The wider cybersecurity and geopolitical aspects are also important, and we may not be able to separate them too much, but we will try.

Against that background, to what extent is China's geopolitical power dependent on its economic growth, how robust is that growth and how come it happened anyway? China was always humiliated and resentful, and always involved in Asian affairs, but not very rich. Over 30 years, it has got to the point where it feels it is so wealthy that it can start asserting its dominance, almost, in world politics. How did that happen and can it last? That is our opening question. I am sorry it is so big, but we will come to the details as we go along.

George Magnus: The place to start is how it all happened. As many of you will remember, and will certainly know or have read, for many years under Mao Tse-Tung, China was revolutionary, violent and isolated, and had as its principal mission the establishment of the party in all areas of economic, social and political life. That all changed around the late 1970s, particularly from about 1980 onwards, when Deng Xiaoping took over as the general secretary of the Communist Party. At one of the very first congresses of the party, he coined the phrase "reform and opening up" as the motif under which China was going to try to develop. Many people are familiar with a phrase that was credited to him, although I am not sure it has ever been proven: "It doesn't matter whether a cat is black or white as long as it catches mice". That was widely interpreted as his way of saying, "Look, we have to become economically efficient. We have to lift people out of poverty. If it means that we have to adopt some of these market-oriented systems that seem to have done so well in the rest of the world, we should do that as well".

To cut a very long story short, reform and opening up really was the motif of China during the 1980s and 1990s, which then paved the way for China to join the World Trade Organization in 2001. There were political and economic accidents along the way, not least of which was Tiananmen in 1989, and between about 1988 and 1992 reform stalled as the conservatives in the Government saw an opportunity to regain control. They failed and Deng's visions eventually won through. The later reforms under Zhu Rongji and Jiang Zemin during the 1990s proved extremely successful. The corporate enterprise scheme of SOEs—state-owned enterprises—was pretty much dismantled, up to a point of course, but there was privatisation, and a very positive environment for the growth of private companies.

World Trade Organization membership was also a very important catalyst, because it promised a lot to the Chinese that they could take advantage of only by making changes in the way that they organised their rules, competition policy and export industries. The consequences of joining the WTO in the 2000s were very positive, in the wake of what proved to be a rising tide of globalisation that lifted all the proverbial boats. It is no accident that in 2005-06 we saw China emerging with a much more confident, almost truculent, attitude to its geopolitical role, as you put it at the beginning. It was not blindingly obvious at the time, but it has certainly become much more obvious subsequently, particularly in the last two or three weeks during the National People's Congress in Beijing.

The short answer to the question of whether China's geopolitical heft is contingent upon or has depended on China's economic success is, in my view: unequivocally. Without that, it would be Russia, which is a very powerful country militarily, but not much of a power in an economic context, and it does not wield soft power in any material way. What China has become politically in the world is very much related to its economic prowess.

The second issue you mentioned, which is equally important, is whether this robust growth and economic performance can be extrapolated into the future. That is a big issue that we may want to come back to. I do not want to take my colleagues' time in the opening statement, but there are some serious reasons to question how sustainable China's model is going forward.

The Chairman: That was very clear indeed. Stefania Palma, can we have your assessment?

Stefania Palma: I agree with George about the direct causality between economic strength and strong geopolitical muscle. I want to illustrate some manifestations of the strong geopolitical capacity that China has built, and how that is directly linked to its economic growth. We will probably be talking about the belt and road initiative later, but a project of that size, between $900 billion and $1 trillion, is considered to be the biggest infrastructure initiative that a single country has ever undertaken. It is focused on infrastructure building, but you could argue that there is also a very strong geopolitical angle to it. For China to support the initiative, it needs the capital to back it up. Although it is true that China often lends to the BRI's host countries, it is also true that you have to have the capital base to be able to lend. You also have to be able to sustain potential losses. China has already said it is expecting losses in some of the countries along the belt and road—the weakest economically—especially in south-east Asia.

China also needs to sustain its development banks, which are lending to host countries in the belt and road. It needs to keep them well capitalised. Furthermore, the Chinese state-owned enterprises, that tend to win the vast majority of construction bids along the belt and road, need to have sufficient capacity to go all over the world to build infrastructure projects.

Another way in which we have seen China flex its geopolitical muscle is over the South China Sea question. I am going to keep this quite short because I am sure we will talk about it later, but just maintaining the position that China is projecting on this matter, which also involves building new land, requires economic strength. A strong economy is needed to undertake these kinds of projects.

Lastly, Latin America is a very interesting case when looking at China's growing geopolitical strength. China has now surpassed the US as the main trading partner for Brazil, which is the biggest economy in Latin America. Since 2015, China has been investing up to $150 billion through its policy banks across the region, and it is now proposing even more investment through the belt and road. The way this has been translating into the geopolitical front is that in recent months Panama, so far the only Latin American country to be part of the belt and road, has severed diplomatic relations with Taiwan, which China does not recognise as a separate state. Meanwhile, Venezuela is in an absolutely dire situation at the moment and China has lent more than $62 billion through policy banks to this Latin American country. As Venezuela started running into trouble, China started including conditionalities in its loans to Venezuela, a further way in which geopolitics is creeping into Chinese cross-border economic relations.

We will talk later about whether China's economic growth will remain strong. A key aspect that stands out is the accumulation of debt in China. It now accounts for more than250% of GDP. Quite a few measures have been taken to address this issue, and I am sure we will discuss them later. Meanwhile, the political angle has shifted completely. I am sure you talked in the previous session about Xi Jinping no longer having a limit on the terms he can serve. How that will impact economic growth can go two ways. The best-case scenario is that a head of state with a very firm grip on power will be able to implement policy reform or policy changes in a far easier way. That is great if the policy reforms work, but what if they do not? That is the worst-case scenario. More power means even more accountability and responsibility on the head of state if things go wrong. Will there be more volatility in the Chinese political system if policies fail when such a powerful leader is heading the country? I leave that as an open question.

The Chairman: Stephen King, there are two questions: is it all about economic growth and power, and will it last?

Stephen King: I want to put China's development into some kind of international context, if I may. In 1980, using the exchange rates of the day, China's GDP was 2.7% of the world's total. In the same year, the US accounted for 25.8% of the world's total, and the UK was at 5.4%, so China was smaller than the UK economically in 1980. By 2007, using the same kind of comparison, the Chinese figures are 6.2%, the US is still at around 25% and the UK is at 5.3%, so, in 2007, on the eve of the financial crisis, China was bigger as an economy than the UK. Using the same comparisons of exchange rates for last year, 2017, China accounted for about 15% of global GDP, the US is at 24.5% and the UK, I am afraid to say, is at 3.2%. The UK share has gone down quite a bit but China's share has gone up enormously.

I want to express those numbers in per capita terms, because, of course, the figures just look at the overall size of the economy and do not take any account of the size of the population. A per capita comparison between China and the US over a much longer period is quite striking. In 1980, roughly speaking, Chinese living standards were the equivalent of those in the US in the 1790s, just after American independence. By 2010, Chinese living standards were the equivalent of those in the US in the 1930s. As a rough rule of thumb, that suggests that China is delivering economically every 10 years what it took the US every 50 years to achieve. What this tells you, of course, is that, over the last 30 or 40 years, China has been plucking technologies that exist elsewhere in the world and incorporating them extremely rapidly into its economy.

I absolutely agree with George that the political power comes from that economic transition, but the economic transition itself, again as George said, comes with a sense of opening up China. It is not just an opening up relative to now; it is an opening up relative to China's history over hundreds of years. The 1430s, when the Ming dynasty destroyed the ocean-going fleet, was the time when China began to close itself in, exit from the rest of the world and disengage from influence elsewhere. There was a forced re-engagement in the 19th century because of the imperial powers, and again because of the Japanese in the 1930s, but I think voluntary re-engagement with the rest of the world starts with Deng Xiaoping. My point is that it is not a revolution over a few decades; it is a revolution over centuries. It is a remarkable shift compared with what we have seen in the past.

There is no doubt that, as China has got bigger, its gravitational pull on the rest of the world has got quite a lot bigger, too. I was talking to some Australian policymakers recently, having a discussion about Brexit, funnily enough, and whether Australia would be a new interesting partner for the UK to re-establish relations with. The Australian response was, "Yes, interesting, but the biggest opportunities that we have in Australia are all with China". Admittedly, Australia is a major mineral and metals producer so there is an obvious connection, but Australia is just one example of countries around the world that are saying, "Whatever we think of the Chinese regime, economically we have to engage with China. We have no real choice in that matter". It is not just Chinese money going out; opportunities for other countries connecting with China have shifted in recent times.

For the West, this is a very interesting challenge. Back in 1989 when the Berlin Wall came down and Francis Fukuyama wrote his famous paper *The End of History?*, the idea in the West was very much that to succeed economically you needed some kind of liberal democracy. That may be true of the very long term, but what China has delivered over the last 30 years is a direct challenge to that particular observation. It is also a challenge to how the West thinks about its engagement with countries elsewhere in the world.

I know you want to discuss the future a little later on. I will mention just one small thing at this stage. There is often a danger of thinking about China as one economy. Actually, it is a series of different regional economies with very different living standards. If you do a comparison of China with, for example, the regions of Japan, the regions of the UK, the countries of the eurozone or the states of the US, you discover that China has levels of regional inequality that are greater than the UK's, greater than Europe's, greater than Japan's and certainly greater than America's. What that might suggest is that even if, for example, the eastern coastal regions, which have done incredibly well over the last 30 or 40 years, stall or falter, part of the importance of belt and road is precisely to connect the inland parts of China with other parts of Asia. If it works—it is a big if—there is an opportunity for further growth not from the coastal provinces but from the other parts of China that so far have been held back dramatically.

The Chairman: That is really interesting. Thank you very much.

Lord Jopling: I would like to go back to the second part of the Chairman's question. How robust is the growth likely to be? In the previous session, we had an analogy of expansion in the 1970s and 1980s as a birdcage; the cage got bigger to allow expansion of the economy. Let me ask you a question about China's biggest industry—agriculture. During the expansion period in the 1970s and 1980s, the Chinese Government said to the farmers in China, "All the food you produce now belongs to the state. Any food you produce in excess of that is yours for you to market and distribute". As a consequence, there was a huge boom in the rural areas and massive increased prosperity, as the entrepreneurship of the Chinese asserted itself. We were told by our previous witnesses that there were signs that the birdcage may be getting smaller. Could you give us examples from the agricultural sector of how that cage is becoming smaller, if it is becoming smaller, and to what extent are the profit motive and semi-capitalism being snuffed out?

George Magnus: Can I ask what they meant by birdcage?

Lord Jopling: There was a birdcage containing a bird—the economy—and during the 1970s and 1980s, in order to adopt the new policy of Deng, they made the birdcage bigger.

George Magnus: I see.

Lord Jopling: The witnesses went on to suggest that there are now signs that the birdcage is getting smaller again, which I suppose means that pure communism is asserting itself.

Lord Reid of Cardowan: Essentially, it is the political framework in which the Chinese were trying to shape economic development.

George Magnus: That is really important, as I am sure your two previous witnesses would have emphasised. In my opening remarks, I said that Mao's China was characterised by revolution and violence and the establishment of the role of the party in every walk of life. Deng's China, which lasted through to the 2000s, was a very different kind of China: it was about reform, opening up, engagement and a mission for economic growth, at almost any cost.

The agricultural example is a very good one. The so-called township and village enterprises, which had been set up even under Mao, were transformed. They were still publicly owned, state-owned, units of production, but they competed with state-owned enterprises and added an element of competition to the economy at a time when other incentives were given for farmers to save. Economies get richer by investing, and people invest by saving, so those incentives were really important for Chinese agriculture at the time.

It is important because in the first five years of Xi Jinping's presidency there were certainly very strong hints as to what was going to happen. We have seen many of those hints corroborated during the last few weeks, and at the 19th party congress last year, with the concentration of power and the intrusion of the party into every walk of life. Party cells in state-owned enterprises were always part of the furniture, but now the operational management of private companies is also being affected by the intrusion of mandatory party cells in those companies, including in foreign companies, by the way. It is a concern for me, thinking about extrapolation, which we cannot really do any more, to reflect on what this additional political flavour in China's economy now means for its growth.

I will supplement that with a few brief observations. The first is that the Chinese get the problem of debt, which Stefania alluded to. It is very definitely one of their top priorities at this juncture. They really want to create financial stability, but only in the context of not letting go of the growth in the economy. Many of us wonder whether it is compatible to do both at the same time.

Secondly, there are structural issues that the Chinese will have to face over the next five or 10 years. Some of them have to do with demography; it is the most rapidly ageing country on the planet. Some of them have to do with the middle-income problems that countries have when they may not be able to get the additional boost of productivity that is often required to sustain growth.

The last thing in this context relates to the problems the Chinese have with the way they architecturally organise economic policy from the top down. As you know, in this country, and in the western world, we obsess about GDP. It is a measurement of what we spend and what we produce after everybody has made their decisions: households, companies, the Government, local authorities and so on. In China, GDP has a completely different connotation. It is mandated as a target to local and provincial governments and to central government, and everybody has to work like billy-o to make sure that target is met, regardless of how commercially unsound the investment projects might be to deliver it. That is a very important distinction.

I do not know if that is what Steve and Carrie were alluding to, but, if I can take that theme, for me the issue is that while China's GDP looks very impressive, at 6.5%, 6.7% or 6.9%, although it has slowed down over the last several years, a lot of that growth is unreal. If China had to account for bad debts, bad investment decisions and commercially unsound lending decisions, growth would probably have been, in my estimation, about a third or more than a third lower.

Sooner or later, somebody has to pay for that. It cannot go on ad infinitum. My feeling is that for a number of different reasons the Chinese Government may not willingly want to slow the economy down yet, because it is still very important to have elevated growth, but there is an inbuilt time clock that almost mandates that in the next five to 10 years—it is very difficult to be specific—there will be a material slowdown in economic growth.

The Chairman: Would anyone like to add to that? What you are saying seems to confirm our rather western prejudice that, in the end, central planning has very heavy costs and does not always work so well, and, if they are going back to more state acquisitions instead of the old free-market ideas, they are going to run into some progressive trouble.

George Magnus: There is one caveat. There are benevolent dictators, and I suppose we could try to think of some. When people talk about them, they normally come up with Lee Kuan Yew and very few others. Benevolent dictators can do good things, and I am sure that China will achieve a lot of great things in science and engineering and all the projects that we might talk about later, but something fundamental about China's governance system has changed under Xi Jinping that augurs not so well for the future.

Q86 **Baroness Hilton of Eggardon:** Can we go back to belt and road for a moment? Most of it is about infrastructure in places such as Myanmar and Laos and harbours in Pakistan and those sorts of big infrastructure projects, but the original ambition, I think, was to drive it through into Europe. Do you think there is any possibility of success or is that ambition likely to fail?

Stefania Palma: *The Banker* magazine, has just published a special report on the belt and road jointly with Nikkei Asian Review. We looked at specific case studies and how this enormous programme is progressing. On the Europe question, belt and road-related projects are definitely happening, especially in eastern Europe, such as in Ukraine and Hungary. One important point about the belt and road generally, to try to understand it properly, is that what constitutes a belt and road project is not set in stone. When you ask that question, there is no definitive answer. There might be countries that have officially signed up to the belt and road and endorsed it publicly, but that have not necessarily benefited much from the initiative as yet. At the same time, there might be countries that have not officially signed up to it but that are already seeing projects that fit the B&R initiative.

India has definitely not publicly accepted the belt and road, on the basis of sovereignty infringement. I interviewed Arun Jaitley, the Finance Minister, a couple of weeks ago in Delhi, and he reiterated that India takes issue with a road project included in the China Pakistan Economic Corridor which passes through the Kashmir region. Both India and Pakistan claim the entire Kashmir region. On a high-level, political basis, India is absolutely against the belt and road, and it refused to go to the belt and road forum in May 2017. At the same time, that does not mean that China is not investing in infrastructure in India. The China Development Bank signed a memorandum of understanding with the

Gujarat Government to put together an industrial park at a cost of $1 billion, which absolutely fits the belt and road remit.

In addition, the speed of construction of belt and road projects is slowing down in a number of countries, even in Kazakhstan, which neighbours China and is often seen as the darling of the entire project. This does not mean that none of the projects have been completed, but quite a few of them are slowing down. The same is happening in Bangladesh and Indonesia. The main reasons are protests or social upheaval in response to greater Chinese involvement in countries along the Belt and Road. It is also due to local bureaucracy, land acquisition problems and permits. The countries in Asia along the belt and road are often developing countries, and the soft infrastructure may not be as developed as required by this kind of initiative.

Another very important point on the belt and road is the question of indebtedness. A lot of the countries that are hosting these infrastructure projects are, as I said, developing countries and have very high government debt to GDP ratios, very high levels of indebtedness. The worst case is Sri Lanka, which recently had China sign a 99-year lease on Hambantota port. China now owns the Sri Lankan port and that is partly because Sri Lanka was really struggling to pay back its debt to China, which stands at about $8 billion. That is another big risk, and it questions the sustainability of this kind of project if Chinese development banks are lending to countries that fundamentally cannot afford to service debt.

Stephen King: Could I add something about institutions rather than belt and road specifically? China recognises that there is an opportunity in Asia, and indeed in Europe, which partly results from the fact that the US is no longer so enthusiastically embracing the global institutions that the US itself helped to create in 1944 and beyond. For example, the Asian Infrastructure Investment Bank, which, arguably, is the underlying bank supporting many of the belt and road projects, was created by the Chinese. Its dominant shareholders are the Chinese. It might work in conjunction with the Asian Development Bank and the World Bank, but there is no doubt that, whereas the Asian Development Bank is led by the Japanese as a proxy of the Americans and the World Bank is led by the Americans, the AIIB is fundamentally different.

I fully accept all the difficulties that other countries in Asia are having domestically and so on. We come back to the idea of gravitational pull and the extent to which there is increasing support for institutions that are China-led, which may have implications for countries elsewhere in Asia. I have mentioned the AIIB, but there is also the regional comprehensive economic partnership, which is a fairly low-level series of potential trade deals with countries across Asia. There is the Shanghai Cooperation Organisation, which is, arguably, an energy security relationship for a number of Asian countries, and, interestingly, includes among its recent members India and Pakistan, which have both signed up to it. We are beginning to witness the creation of 21st-century institutions that look rather like the globalisation institutions of the mid-20th century, but they are China-led rather than American-led or European-led. There is a different flavour to them. They may be rivals to the existing institutions or they may simply be bolt-ons to those institutions, but they are different and they reflect China's increasing political reach.

The Chairman: I think you have answered a question that Lord Jopling was going to ask.

Lord Hannay of Chiswick: I wanted to try to understand whether what you are really saying about the belt and road is that there is an element of Potemkin village about it, in that it is not all quite what it seems, and, to some extent, it is just a massive governmental branding exercise, many of whose component parts would have been there anyway. For example, Pakistan is a country where China has a huge geopolitical stake, and always has had, and it did not need the belt and road to invent that. Am I right in thinking that you are saying that there is an element of Potemkin village in all this?

George Magnus: You should have written the chapter I have just finished on this in my book. I might well ask you if I can borrow your phraseology. It is a very good point. I have a slightly different view from Stephen. I think China wants to play by the rules of established international organisations, up to a point, because the last thing that China wants is chaos and instability. The Chinese want and like a very rules-based governance structure, but, of course, it is their rules that they want to establish rather than the rules they deem the Americans and the West have put in place over the last 60 or 70 years.

Belt and road has no formal institutions. There is no international architecture, or even Chinese architecture outside the institutions within China. There is no secretariat where countries participate by sending people, resources and staff. There are no formal commitments to rules about corruption, transparency or openness, or the way contracts are drawn up and what the implications for third parties might be. If you wonder whether the belt and road is something between a Eurasian development project, along the lines of a Marshall plan for the 21st century, and a very China-specific branding, as you call it—I cannot remember your exact phrase—yes, that is precisely what I think it is. That is not to say that countries that are recipients of Chinese financing do not benefit from having dams and high-speed rail projects and all the stuff that comes along with them. Of course they do. But this is very much about China, and not very much about building an international architecture at all.

The Chairman: Lord Hannay, would you like to continue with where we come into all this, considering your expertise in this area?

Q87 **Lord Hannay of Chiswick:** Could you focus a little on the importance of the economic aspects of the UK-China relationship? How important is China to us? How important are we to it? Perhaps in addition, and slightly more speculatively, what sort of trade relationship ought Britain to be trying to achieve with China post Brexit—realistically trying to achieve, not aspirationally?

Stefania Palma: I guess from the trade point of view, the UK definitely imports more Chinese goods than the UK sells to China, so there is an obvious imbalance. On the possibility of the UK getting its own way when it tries to change that kind of trade relationship, I do not feel that I could say for certain that the UK would be able to get its own way with a country such as China.

What I find interesting about the UK-China relationship is the outbound direct investment between the two countries. Just to give you an idea, I pulled up some data on outbound M&A from China to the UK. The increase has been phenomenal. From 2011 to 2017, it increased twentyonefold; in 2017, it totalled $21 billion. If we look at it the other way round, UK outbound M&A to China was just $54 million in 2017. It is true that China is a far harder market to crack for a foreign company wanting to engage in M&A, but there still is a very stark difference in terms of the firepower and capital that can be put to work cross-border between the two countries.

However, the UK can offer some technological capabilities that China is still looking for. In the last 10 years, the type of outward direct investment by China has changed enormously. At the very beginning, it focused mostly on commodities and real estate. Today, there is still quite a bit of real estate investment but China is also focusing on services and technology. The UK has interesting companies that China could look at. For instance, there was Chinese investment in House of Fraser and in Weetabix two or three years ago.

During one of my research projects, I found another very interesting example. A 12-person company in Cambridgeshire called Kore Technology produces mass spectrometers, which identify atoms by measuring their mass. For the entire lifespan of the company, these have been used mainly for medical diagnosis, but they can also be used for pollution measurement. In 2015, a Chinese company bought up 51% of that small firm, and now Kore Technology is selling hundreds of its products to Chinese cities that need to reduce pollution levels.

The owner of the company told me something that I hope will resonate specifically in this context. One of the reasons why he looked at a Chinese investor to begin with was, to paraphrase his statement: We did not have enough government support for research and development, especially sufficient support for UK start-ups, and he gave some comparisons with the US having special programmes for start-ups. Although the company received some tax breaks, it was not sufficient to help grow a very small company like Kore Technology. A Chinese investor came in, saw technology it needed to bring back to China and offered Kore Technology the capital it was looking for. That is a very interesting example of how some UK companies still have a lot to offer China, even post Brexit.

George Magnus: To supplement that, clearly the direct trade relationship we have with China, as Stephen pointed out, is pretty small, certainly next to Germany, for example. Some 3% to 3.5% of our exports go to China. The other side of that is that the UK has been China's number one choice, as Stefania pointed out, for foreign direct investment, for several years at least. We account for about 25% of China's foreign direct investment in the EU. We have things that the Chinese want, specifically in technology. They are interested in utilities, energy and consumer products, but technology is what they are really interested in. We have to decide whether it is something we want to sell them.

Stephen King: If you benchmark the UK against both France and Germany on exports to China, the UK and France score pretty similarly. In one sense, Germany is the exception. It has been very successful over the course of the last few years. One possible reason is simply the make-up of German exports, which are in engineering and investment goods of one sort or another, the kinds of things that a country that is growing quickly from a relatively low base tends to want to consume.

Some more positive arguments about the UK are that, once you get to a certain level of per capita income in China, the balance of trade begins to shift towards more services—professional services, financial services and so on—so at some point we may see a kind of flip-over from German success to UK success. That may be overly optimistic, but it is one way of looking at that particular story.

As far as technology is concerned, I remember speaking to a Chinese diplomat who said, "The reason why we love investing in the UK is, first, that it is very difficult to invest in the US and, secondly, you have some reasonable technologies". It was that straightforward and simple.

On post-Brexit success in linking with China, back in 2008, just after sterling had fallen during the global financial crisis, and people in the UK were talking about rebalancing the UK economy away from consumption and towards export, I talked to a senior diplomat in China and explained to her that this was the UK story, and what the UK hoped to do. She looked at me with a slight smirk on her face and said, "But you don't export anything". I pointed out that that was grossly unfair, but the point she was making was that the UK does not have the reputation for exporting to China that, for example, Germany or Japan currently have. Even if there are opportunities, certainly back then the UK had a serious branding problem compared with other countries.

Lord Hannay of Chiswick: It is not a question of what we could do better even if we were still a member of the European Union. It is what we could hope to do better if and when we cease to be a member of the European Union and are in a bilateral trade negotiation with China. None of you has answered that question. It would be quite helpful if you could say whether there is anything there at all. Of course, your answer may be, "No, there is nothing there". Most of the public comment about Britain in this context ignores the fact that there is nothing in the EU make-up and its relationship with China that prevents us doing far better. It is only our own inability to do so.

Stephen King: It is true that over the last few years the UK's performance in emerging markets more generally, rather than China specifically, compared with its peers in Europe, has been generally poor. The fact that we are in Europe but not doing as well as other Europeans might suggest that, if we are out of Europe, there is no particular reason why we would suddenly do better than our own history, or, indeed, suddenly do better than other European countries.

When China is thinking about the prioritisation of trade deals with the EU versus the UK, the trade deal with the EU may be much more complex but the rewards for China are much greater than doing something with the UK. The other complication for the UK is that it is all very well trying to do trade deals with countries elsewhere in the world if they all happen to agree with each other at the same time, but if you are trying to do a bilateral trade deal with China and a bilateral trade deal with the US, while at the same time the relationship between the US and China is potentially breaking down, as is a danger currently, your ability to do bilateral trade deals with both at the same time may be significantly reduced.

George Magnus: I think that is right. The structure of our exports is not best aligned with the structure of the Chinese economy. A lot of what we send China are consumer products, motor cars, and gold; we happen to be a gold export hub, much as Dubai is a hub for international airline passengers. A lot of our exports to China comprise gold that is routed through the City.

The two points that Stephen made were spot on, one in particular, which is that if we believe that we need to do more trade with big economies in the world, particularly once we leave the EU, China is an obvious case because it is a huge market. Services are a big problem, because the Chinese are very slow. The Americans have been badgering them for donkey's years to open up their service sectors to allow in more financial services companies, professional services, business services and so on. It is a head against a brick wall problem to get them to open up to foreign competition. That is not to say that we should not try, but the chances of being able to do that without some sort of collective weight behind us are slim. We wonder nowadays about America First and what our political heft might be vis-à-vis the United States, in a big versus small economy, but there is a China First trade and investment policy, too, which gives China a huge amount of leverage, which we need to compensate for somehow. On our own, it will be very difficult.

Stefania Palma: Especially considering what is happening in the US now and how sour trade relations could get between China and the US. The US is the biggest export market for China, so for now, China will focus on trying to keep that trade relationship stable. That will be its top priority and in that context, when the White House is trying to sharply rebalance such a large trade relationship, it might become quite difficult for a country such as the UK, whose trade with China is not comparable with the US's, to jump the queue and try to establish bilateral trade relations with Beijing. The UK's trade volumes with China are not enormous. To play the devil's advocate here, I would argue that in being part of a bloc like the European Union there would have been more strength in numbers to deal with such a massive player like China, which, whether we like it or not, has the upper hand versus the UK when it comes to trade.

Q88 **The Chairman:** Alas, time is getting on. Lord Purvis is going to ask a question, but I will precede it with a related question. Perhaps we could both put our questions and get answers from all three of you. They are about technology, about Tencent and Alibaba, some of the world's biggest firms in China. They are in AI, quantum computing, blockchain and all the rest. Are they now ahead of us in electronic and information technology, as a newspaper report suggested yesterday? Are we going to have to learn from them? Lord Purvis, could you put your question from the other side, about the great global companies, and then we can have an assessment from all three witnesses?

Lord Purvis of Tweed: Do the large multinational companies that operate in China have the scope for changing China's policy or the way that China develops in the future? They seem to have a large amount of influence in many countries, on the way that the countries are governed and on their regulatory frameworks, and their view on trade regulation and non-tariff barriers. Do they have any scope for influence on China going forward?

Stephen King: One way to consider China's success over the last 30 or 40 years is, oddly, that it has been prepared to listen and to learn from how companies elsewhere in the world have done things. It is not as though China started growing in 1980 with no outside help. It had huge amounts of FDI inflows. A series of joint partnerships and joint ventures was established between western or Japanese companies and Chinese companies. There was a desire to learn not just how to do things from a technological point of view, but how to organise things, and how to have governance within companies, which was sometimes successful and sometimes not. There was a sense that unless China embraced those ideas and was open to them, it was unlikely to succeed.

It is also true that over that period some companies involved in China were reasonably successful and others had embarrassing failures from time to time. What will happen is not entirely predictable. The rules change rapidly in China, and sometimes they are favourable and sometimes they are not. It is important to stress that China has taken the view that it should develop by learning from other countries. That is in contrast to, say, Japan or South Korea, which were on earlier but arguably similar development paths. In their cases, companies were created from within and were forced, effectively, to produce goods that were going to compete in the outside world, but on their own terms. Very little FDI went into Japan and South Korea. A lot more went into China. To that extent, you could argue that China has tried to fast-forward the process of economic development precisely by importing skills, technology and knowledge from other parts of the world.

Whether that will continue is debatable, because a lot of Chinese companies have now become successful, not just within China but, arguably, internationally as well. Ten or 15 years ago, people used to say to me that there were no Chinese brands, and they were never going to succeed. Now we can list quite a large number of Chinese brands that are succeeding. That suggests that there has been a shift in China whereby there has been a learning process from foreign companies, but there is no guarantee that the foreign companies themselves will do well continuously in the Chinese situation.

George Magnus: For many years, the European Union Chamber of Commerce in China and the U.S.-China Chamber of Commerce have been the principal lobbying organisations in Beijing trying to get Chinese policymakers to listen to their complaints and issues about being successful in China. There has been a very distinct change in tone since 2011 or 2012. Previously, a lot of companies were prepared to overlook things such as technology rip-off, IPR abuse and so on, because labour was cheaper and the market was growing by leaps and bounds. The balance of views among those organisations has changed; they now feel that what they regard as the abuses of the Chinese authorities have meant that the scope for manoeuvre and for negotiation by multinational companies in China is much more hostile.

We can see in the succession of policy documents, which the Chinese, to pick up your question, Lord Howell, have issued since about 2014 or 2015, to do with artificial intelligence, robotics, 5G, quantum computing, modern manufacturing, autonomous vehicles and so on, that the Chinese want to do it on their own. The latest document, for example, has a goal of being "competitive with other global producers in advanced technologies by 2025" and being the "primary source" of those technologies by 2035. I do not think that means that they will shun multinational companies and turn them away from China, or anything like that, but they want to do it on their own and they think they can do it on their own. You need to get AI experts and technology experts in here to tell you whether or not that is viable, but it is certainly the Chinese intention.

Stefania Palma: From the financial services point of view, and the application of technology to finance, China has demonstrated that it is miles ahead of the West. The kinds of results that companies such as Alibaba, Tencent or Baidu have managed to achieve in the space of 10 years is really remarkable, versus institutions such as Google, Amazon or Facebook, which, to this day, have not been able to leverage the kind of user data they have from a financial services point of view. The fintechs in China work on enormous user bases. To give you an idea, Alibaba's user base is 400 million people, which is five times Germany's population. Tencent's messaging service, WeChat, has 1.5 billion single users per month.

China's tech giants are using their user data to solve the biggest unresolved question in banking globally, and also in China, which is establishing solid credit scoring. They are able to serve groups of people such as retail customers or small and medium-sized enterprises that have historically been underserved by traditional banks in China. It is very hard and costly to do proper credit scoring on those kinds of clients, but Chinese fintechs have found a way to do so in a cheap and effective way thanks to the user data they possess.

A difference between what fintechs are doing in China and in the rest of the world is that in China they have literally come in and disrupted the entire financial system. Whereas A lot of the fintechs in the UK or the US are nibbling away at some financial services, perhaps in the retail sector, or they may be doing a bit of foreign exchange or some digital payments. The difference in China is that fintechs are fully fledged banks. Those technology giants are getting banking licences from Chinese financial regulators, and that is a completely different ball game.

I am not optimistic about multinationals influencing China. We only have to look at the series of apologies from large multinationals in the last few months. Mercedes issued a formal apology to China after quoting the Dalai Lama on Instagram. Marriott International had to apologise after a US-based employee liked a tweet that was supporting Tibetan independence. Qantas Airways had put Taiwan in its website's dropdown menu as a country when China does not recognise it as an individual state, so Qantas had to apologise as well. These are massive international companies, yet they still have to respond to the Chinese Government in ways that, arguably, they would not do anywhere else in the world.

The Chairman: We would love to sit with you for another hour at least. I think "disruption" is the spearhead word in this whole scene, and you ended on that note. The entire planet's system is being disrupted by powerful forces, of which the growth of China is one and technology is clearly another. Thank you all very much. I regret that we cannot go on, but the imperative of the lunch break has arrived. Thank you very much for your enormous wisdom, which has helped us greatly in our inquiries.