



Importing for Export Success

January 2014

Executive Summary

The need to support UK exports is well understood, but getting the policy on imports right is also vital for the health of the UK economy. Far from damaging jobs and industry, imports are important growth drivers. They can boost productivity and help to maintain the UK's competitiveness in the global marketplace.

By importing component parts, UK businesses are able to grow exports even faster through the added value they can create. This is vital if we are to balance the trade deficit.

- Over the past 10 years, UK manufacturers have benefited from importing component parts that can be produced relatively more efficiently abroad than at home. This has enabled businesses to focus their resources on adding value to exports through research and development, for example.
- Since the early 1990s imported inputs have contributed a growing share of the UK's manufacturing output, helping it to remain competitive. Over the past decade imports of pharmaceuticals have risen particularly sharply – and this remains one of the UK's leading industrial sectors.
- The report shows that major UK success stories such as transport equipment, chemicals and machinery have benefited from imports from an increasing range of foreign suppliers. This fragmentation of the supply chain has allowed UK producers to secure an above average share of world trade in these sectors.
- Productivity has also benefited from imports. Drawing on OECD research, the report estimates that between 6% and 12% of the increase in manufacturing productivity between 1998 and 2008 can be accounted for by an increase in imports, depending on the industry. As the share of imports in the economy rose, manufacturing productivity improved.
- Even after these gains, the report forecasts that between 4% and 7% of the increase in UK manufacturing productivity over the next 10 years will be facilitated by increased imports of intermediate goods. Imports can therefore be considered as a key part of the UK's export success story. To maintain its competitive advantages in trade, the UK must continue to invest in Research and Development, education and training.



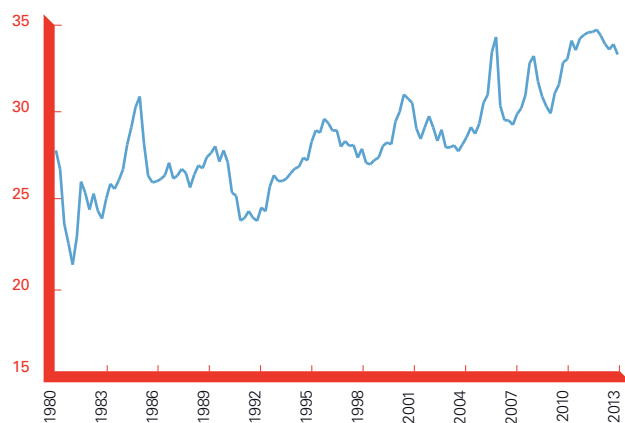
How the UK Benefits from Imports

Imports are essential for the UK economy. Not only are they a source of goods and services that cannot be produced in the UK (such as coffee) or in sufficient quantities (oil), they also lower prices by providing access to goods and services produced more cheaply abroad. Consumers can benefit from cheaper clothes, for example, but businesses also benefit from lower input costs. This keeps production costs down and improves productivity, enabling UK industry to maintain its competitive position in export markets. Importing basic component parts can enable businesses to raise productivity by focusing on creating added value, higher up the production chain.

Chart 1: Imports as a share of GDP

Since the early 1990s, the share of imports in the UK economy has been on a rising trend.

% GDP



Source: Oxford Economics/Haver Analytics

Many UK businesses source component parts more cheaply from abroad, helping them to improve their efficiency and profitability.

Conventional wisdom holds that imports displace domestic production and employment. Although it is true that imports are subtracted from total domestic expenditure when calculating GDP in the National Accounts, the simple conclusion that imports are damaging the economy is a misconception. In fact, many UK businesses source component parts more cheaply from abroad, helping them to improve their efficiency and profitability and the correlation between openness to imports and economic growth is positive.

Evolving Supply Chains

The production processes of many UK firms have evolved to take advantage of shifting patterns of global trade and production.

Intermediate goods, as distinct from raw materials, are semi-manufactured components or inputs used in the production process. The downward trend (chart 2), reflects the fact that the UK economy overall is increasingly focusing on the higher-value-added investment and consumer goods sectors. Within the UK manufacturing sector, however, the share of intermediate goods imports is still increasing. This indicates that the sector is benefiting from sourcing foreign component parts as it increases its integration into global supply chains.

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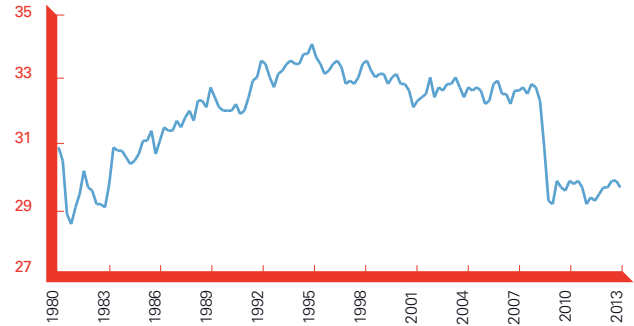
The share of intermediate goods in total UK production has declined since the early 1990s (chart 2).

This helps to explain why manufacturing sectors such as pharmaceuticals have experienced a significant increase in their share of total UK imports over the past 10 years – the increase in import volumes (chart 3) in this sector in part reflects intermediate inputs into the UK's own burgeoning pharmaceutical industry.

This trend is especially evident for industries where there has been considerable international fragmentation of production – mainly high-technology industries where the manufacturing process is complex. These global supply chains that result in the UK importing intermediate goods and components to the manufacturing process have resulted in a growing foreign value-added share of UK exports in the transport equipment, chemicals, metals and machinery and equipment sectors (chart 4). Importing component parts from wherever they are made most efficiently has helped these sectors to secure their position as some of the UK's most competitive and successful sectors in recent years.

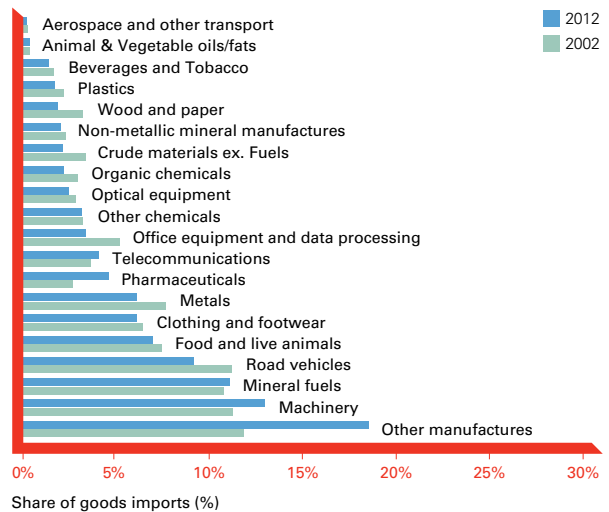
Chart 2: Share of intermediate goods in production

Share of manufacturing value-added (%), Real



Source: Oxford Economics/Haver Analytics

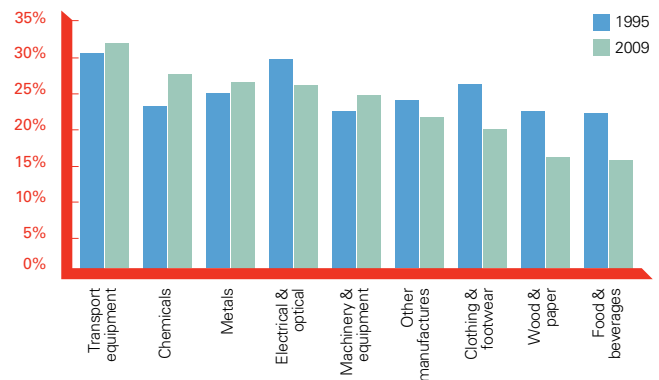
Chart 3: UK merchandise imports by sector (volume)



Source: Oxford Economics/UN Comtrade

Chart 4: Foreign value-added share of UK exports

Share %



Source: Oxford Economics/OECD

The UK's comparative advantages lie in R&D-intensive sectors such as organic chemicals, machinery and pharmaceuticals. The UK produces a wide range of high quality chemical and pharmaceutical products, benefitting from strong capital investment and highly-skilled workers.

The UK also has a strong competitive advantage in the machinery sector, especially in producing engines for the aerospace industry. This sector alongside others has seen an increase in imported components, suggesting that specialisation in the global supply chain is boosting the UK's international competitiveness.

Productivity growth depends on a number of factors such as innovation and R&D expenditure. One of the factors supporting productivity growth within manufacturing sub-sectors has been increasing imports of goods further down the value chain to create more efficient production and specialisation higher up the supply chain.

Research by the OECD shows that increasing the imported share of intermediate inputs by 10% would increase productivity by around 3% – quite a substantial boost, with a clear benefit for the whole economy. The research indicates that it is not just the volume of imported intermediate inputs that matters but also the type of inputs, with raw materials having a smaller effect than semi-manufactured inputs. As such, the link between imported inputs and productivity is found to be even stronger for light manufacturing industries, such as wood and furniture, non-metallic and plastic materials, with a 10% increase in the import share of intermediates leading to a 6% rise in productivity.

Many of the sectors where UK import growth is forecast to be strong over the next decade will also see even stronger export growth.

It is these semi-manufactured intermediate products such as basic pharmaceutical products that are most likely to characterise demand for imported inputs from UK manufacturing as it further integrates into global supply chains in the coming years. Even though they already account for a substantial proportion of

the UK's traded goods, sectors like machinery and pharmaceuticals are still expected to see substantial growth in both exports and imports. Many of the sectors where UK import growth is forecast to be strong over the next decade will also see even stronger export growth. This is partly because importing basic pharmaceutical compounds, for example, frees up capital and workers to develop more complex drug treatments where the potential returns on investment (and benefit to consumers) are much higher.

Based on the OECD estimates and on historical data on productivity and trade, we can assess the impact of the increase in intermediate inputs on UK manufacturing productivity. Our analysis suggests that between 6% and 12% (the range depends on the type of industry considered) of the increase in manufacturing productivity in 1998-2008 can be accounted for by an increase in imports. This means that as the share of imports in the economy rose, manufacturing productivity improved. Applying the same exercise over the next decade and using our forecast for imported inputs suggests that between 4% and 7% of the increase in UK manufacturing productivity over the next 10 years will be facilitated by increased imports of intermediate goods.

The forecast figure is below the historical one, due to the benefits of sourcing production from the cheapest suppliers diminishing, alongside a reduction in the opportunities for finding cheaper inputs.

What Does This Mean for UK Trade?

Export growth is expected to pick up over the next few years. We expect total UK goods exports to approach 4% growth a year in 2014-15, rising to 6% a year in 2016-20.

This expected growth will be increasingly driven by high-technology manufactured goods. Around half of the forecast growth in total exports in the years to 2030 will be driven by just two sectors – industrial machinery and transport equipment, with pharmaceuticals also making a significant contribution. We expect UK goods exports to Asia to grow particularly fast over the next decade, with strong growth also to the Middle East and North Africa.

Smart imports will help to support this growth, and businesses expected to benefit most will be in the higher value-added industries where the UK commands a competitive advantage. The industrial machinery and transport equipment sectors alone will account for around 30% of the growth in imports by 2030. To take investment equipment as an example, UK exports to China of goods required by businesses to boost production are forecast to grow by 12% a year between 2013 and 2030. Amongst the 25 major trading nations covered in the HSBC Trade Forecast, this will take the UK's share of China's export equipment market from 4% to almost 9%. Meanwhile, the UK's imports of Chinese investment equipment will grow by 10% per annum.

Although it is not possible to use trade data to trace the progress of particular imports through the UK production process and out again, the data does suggest that by importing component parts, the UK is able to grow exports even faster through the added value it can create. This highlights the nature of trade in developed markets where value is added at multiple stages around the world, wherever it is most efficient to do so, even if this means importing component parts from China, adding value, and re-exporting the finished products.

Over the medium term, the UK's ability to maintain its lead in R&D intensive manufacturing sub-sectors will depend very much on its ability to continue to evolve and respond to the changing competitive landscape. The UK has one of the most highly-educated workforces in the world, but attempts to encourage more people in the UK to study science, technology, engineering and maths (the "STEM subjects") have not proven successful. This raises some concerns over the UK's ability to maintain its comparative advantage in R&D-intensive sectors through its dominant role in global supply chains.

A View to the Future

Manufacturing sub-sectors also face their own specific challenges. Below we examine in more detail the outlook and challenges facing some of the UK's major export success stories.

- **Organic chemicals** is one of the UK's largest industries, but emerging markets such as China and India have already become strong global forces in the sector (mainly supplying other emerging economies). With the UK's domestic supplies of oil and gas declining, it is likely that firms will come under increasing pressure from Middle Eastern countries. And with future growth in global demand likely to be strongest in the emerging markets, the UK's historic lack of success in penetrating these markets could be an impediment to growth.
- The slow recovery in the Eurozone will hold back growth in **machinery** exports to the UK's traditional trading partners on the Continent. UK exporters will therefore need to look for new opportunities further afield in emerging markets in order to find stronger growth opportunities. But countries such as China are already building their capacity in this sector and this is expected to further erode the UK's share of global exports.
- A major UK success story in recent years has been the UK's **car manufacturing** industry, which has rebounded strongly following a long period of restructuring. Helped by high levels of innovation and R&D, our forecasts indicate that UK car manufacturers will be able to build on their recent success with further strong growth in exports over the next 10 years.

Summary

Overall, the forecasts show that the UK will continue to benefit from trade and outsourcing of production, but an increasingly competitive environment underscores the importance to the UK of maintaining its comparative advantages by investing in R&D.



Summary and Conclusion

A key driver of world trade over the past two decades has been the growing international nature of manufacturing supply chains. These trends have also shaped UK businesses, encouraging them to outsource production of lower value-added intermediate inputs and to specialise in the higher value-added sections of the supply chain.

An openness to imports has improved productivity in the UK and helped to maintain its competitiveness in the global marketplace. Over the past 10 years, manufacturers have benefited from importing component parts more cheaply than they could be produced at home. This has enabled businesses to focus on adding value to exports in areas of comparative strength, such as R&D. In the same time frame imports of pharmaceuticals have risen particularly sharply – and this remains one of the UK's leading industrial sectors.

Increasing fragmentation of the supply chain has also allowed UK producers to secure an above average share of world trade in sectors such as transport equipment, chemicals and machinery. Productivity has also benefited from imports. Between 6% and 12% of the increase in UK manufacturing productivity between 1998 and 2008 can be accounted for by an increase in imports, depending on the industry. As the share of imports in the economy rose, manufacturing productivity improved. Even after these gains, we estimate that between 4% and 7% of the increase in UK manufacturing productivity over the next 10 years will be facilitated by increased imports of intermediate goods.

Imports are therefore a key part of the UK's export success story. Policies to maintain the UK's openness to trade – both imports and exports – are essential to enable UK industry to compete in the expanding global marketplace. And the UK's ability to maintain its lead in R&D intensive manufacturing sub-sectors will depend on its ability to continue to evolve and respond to the changing competitive landscape. The UK must continue to invest in education and skills if it is to maintain its competitive advantages at the higher end of the supply chain. It must also provide the fiscal incentives for businesses to continue to invest in R&D.

About the data

About the HSBC Trade Forecast – Modelled by Oxford Economics

Oxford Economics has tailored a unique service for HSBC which forecasts bilateral trade for total exports/imports of goods, based on HSBC's own analysis and forecasts of the world economy to generate a full bilateral set of trade flows for total imports and exports of goods, and balances between 180 pairs of countries. Oxford Economics produces a global report for HSBC, plus regional reports and country specific reports on the following 23 countries: Hong Kong, China, Australia, Indonesia, Malaysia, India, Singapore, Vietnam, Bangladesh, Canada, USA, Brazil, Mexico, Argentina, UK, France, Turkey, Germany, Poland, Ireland, UAE, Saudi Arabia, and Egypt.

Oxford Economics employs a global modelling framework that ensures full consistency between all economies, in part driven by trade linkages. The forecasts take into account factors such as the rate of demand growth in the destination market and the exporter's competitiveness. Exports, imports and trade balances are identified, with both historical estimates and forecasts for the periods 2013-15, 2016-20 and 2021-30. The model looks at two-digit classifications from the UN Comtrade database, grouped into 30 sector headings. More information about the sector modeling can be found on <http://www.globalconnections.hsbc.com/>

Importing for Export Success – Methodology

The 'Importing for Export Success' report uses the bilateral trade data described above as the starting point for a detailed investigation of how the UK economy benefits from imports and free trade more generally.

In order to assess the impact of intermediate imports on UK manufacturing productivity, Oxford Economics employs the results of OECD research on the link between trade and productivity growth. This research suggests that increasing the imported share of intermediate inputs by 10% would increase manufacturing productivity by around 3% on average (or up to 6% for light manufacturing industries). These estimates are applied to our trade dataset for the UK to provide the estimates detailed in the main report.

The HSBC Trade Forecasts used in this report relate to the nominal value of exports/imports of goods. This means that the growth rates are significantly higher than the equivalent volume measures. Although consistent, the forecasts presented here differ from the official HSBC Global Research forecasts of exports/imports, which relate to volumes of goods and services.

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