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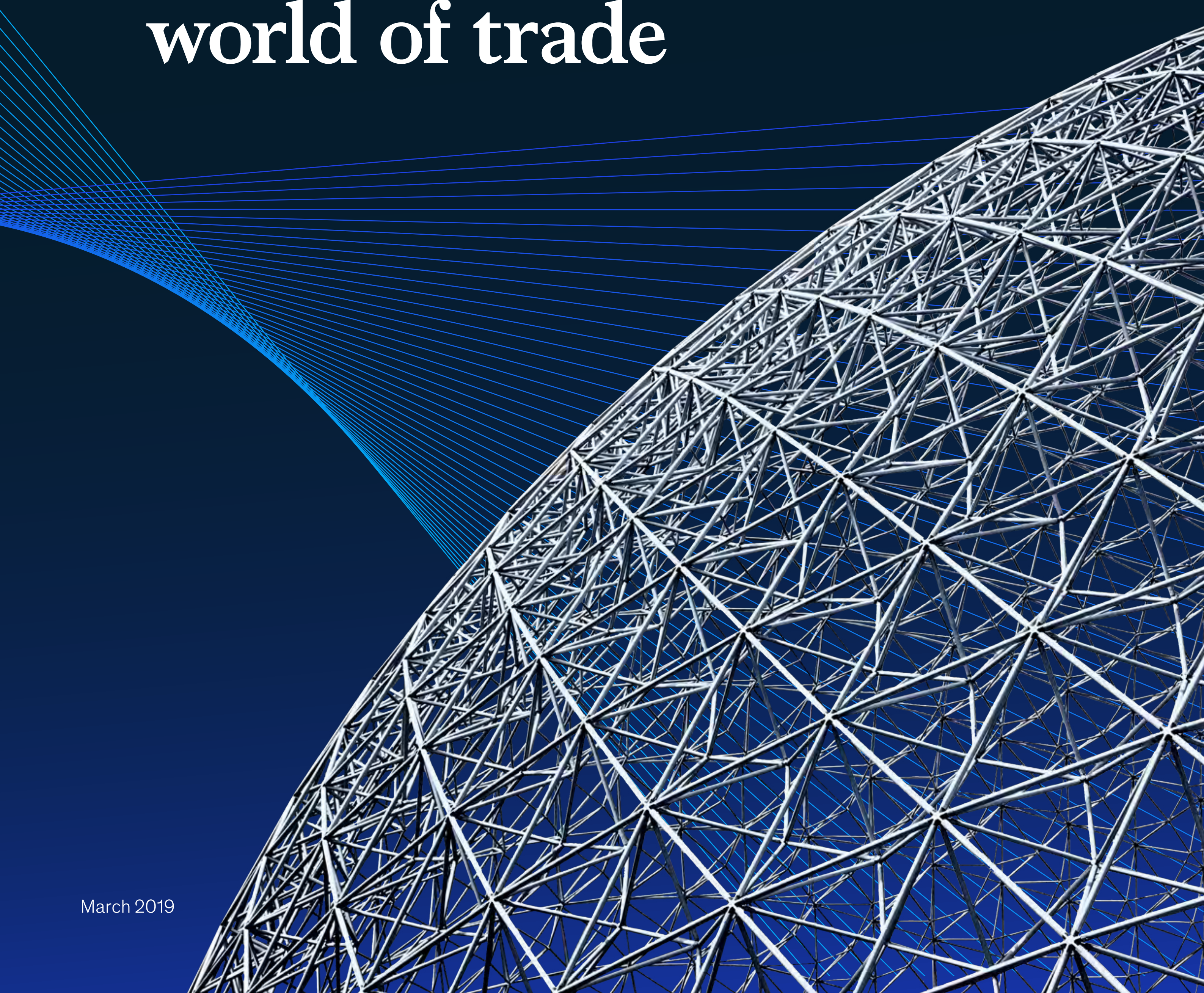
Brexit: The Bigger Picture — Revitalising UK exports in the new world of trade



March 2019

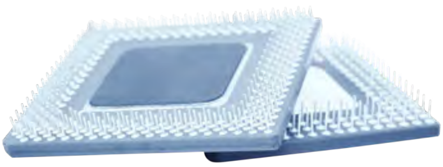
Brexit: The Bigger Picture — Revitalising UK exports in the new world of trade

UK companies can navigate shifts in global trade patterns by focusing on fast-growing services and digital trade, redoubling efforts in emerging markets, and digitising their supply chains.

— by Tera Allas, David Chinn, Vivian Hunt, and Daniel Mikkelsen

Trade and exports have always been critical engines of the United Kingdom's economy. Today, however, global trade patterns are shifting dramatically, with Brexit being just one element in a changing landscape. In this article, the first in a series by McKinsey's United Kingdom and Ireland office, we consider how UK companies can best navigate those shifts and build fast-growing, agile businesses. We draw on recent research by the McKinsey Global Institute (MGI) and other colleagues at McKinsey, as well as on the experience of some of the United Kingdom's most successful businesses.

Our message is clear: it is time to stop waiting for the uncertainty about Brexit to disperse. Whatever the outcome, there are global megatrends at play that need attention now. To sustain and sharpen international competitiveness, UK businesses must seize opportunities in the fast-growing services and digital trades, intensify efforts in emerging markets, and reconfigure supply chains to take advantage of new technologies.



85%

The domestic content of the United Kingdom's exports is high, at 85 percent, compared with the world average of 74 percent.

UK exports: a core national asset

The United Kingdom is the fifth-largest exporter in the world, in value-added terms. Roughly 70 percent of FTSE 100 companies' revenues come from overseas. UK companies enjoy a comparative advantage in a wide range of sectors, from insurance to food and drinks to chemicals and pharmaceuticals. Even for products that the United Kingdom predominantly imports, such as clothing, some of the components (for example, the original design and recycled materials) often originate in the United Kingdom.

The United Kingdom excels in services exports, which, in value-added terms, are almost twice the value of its goods exports (Exhibit 1). It has the second-largest market share in traded services globally. Moreover, it generated around 8 percent of the value of intangibles crossing the world's borders in 2017, with more than a quarter of that coming from its healthcare and pharmaceuticals sectors. The United Kingdom's services exports are highly diversified, ranging from financial and professional services to IT services to advertising to R&D (Exhibit 2). It has trade surpluses in all services sectors, except travel and tourism and government services. Services exports are also well distributed regionally: as a share of GDP, they are above the global average in more than 60% of the United Kingdom's 168 local areas.

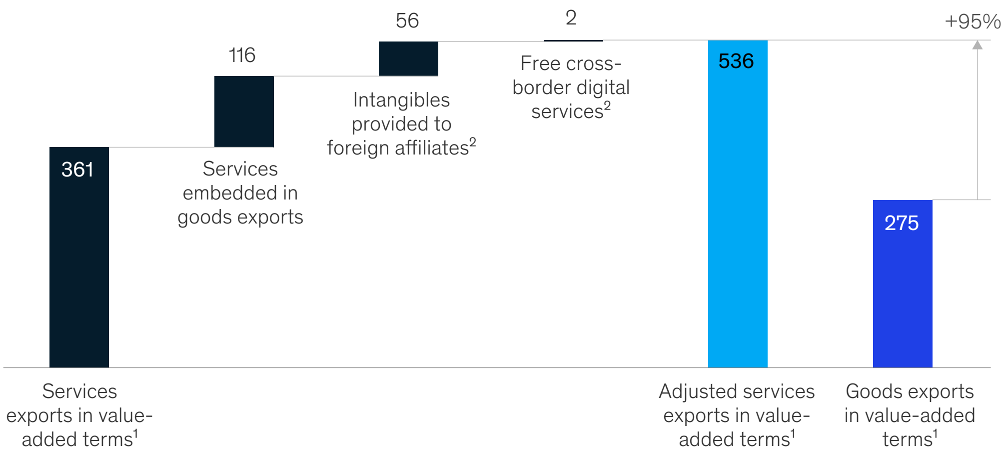
The picture is not entirely rosy, however. It is cause for concern that the United Kingdom's overall share of global exports has been declining. Even its strong position in services is under pressure: its share of global services trade declined from around 9 percent in 2007 to around 7 percent in 2017 (Exhibit 3). This has implications for both individual businesses and the whole economy. The United Kingdom's exporting companies are more profitable and more innovative than non-exporters, and they grow faster.

Moreover, the domestic content of the United Kingdom's exports is high, at 85 percent, compared with the world average of 74 percent. That underscores the significant benefits that exporters create beyond their own businesses through their employees, value chains and participation in local communities.

Exhibit 1

The United Kingdom's services exports are nearly twice the value of its goods exports

2017 UK exports in value-added terms, $ billion

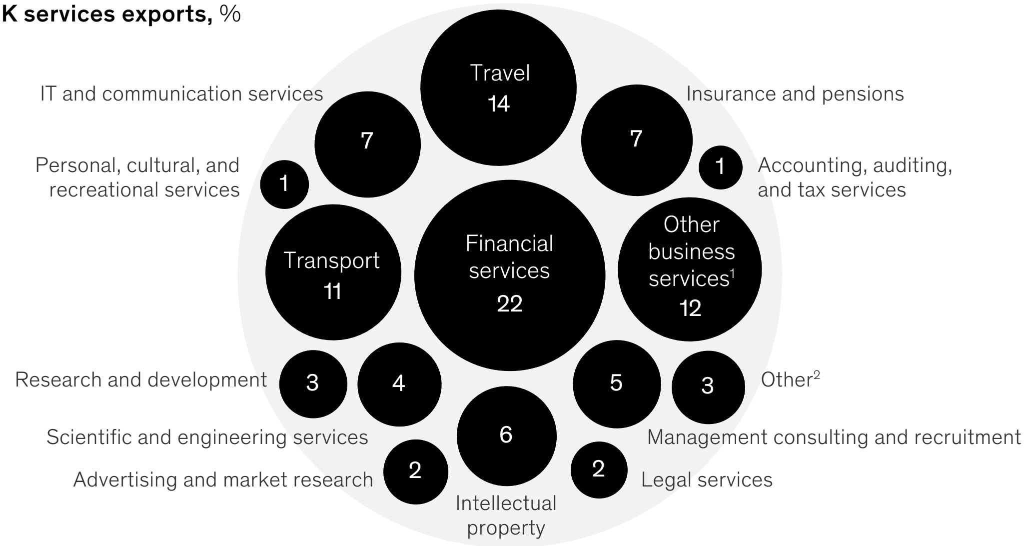


[1]Includes only domestic value added of exports, rather than gross exports. For comparability, value of services embedded in goods trade, and value of goods embedded in services trade, have been removed.
[2]Higher-end estimate.
Note: Figures may not sum to listed totals, because of rounding.
Source: Alexa Web Information Service; International Monetary Fund; S&P Capital IQ; World Input-Output Database; World Trade Organization; McKinsey Global Institute analysis

Exhibit 2

The United Kingdom's services exports are highly diverse

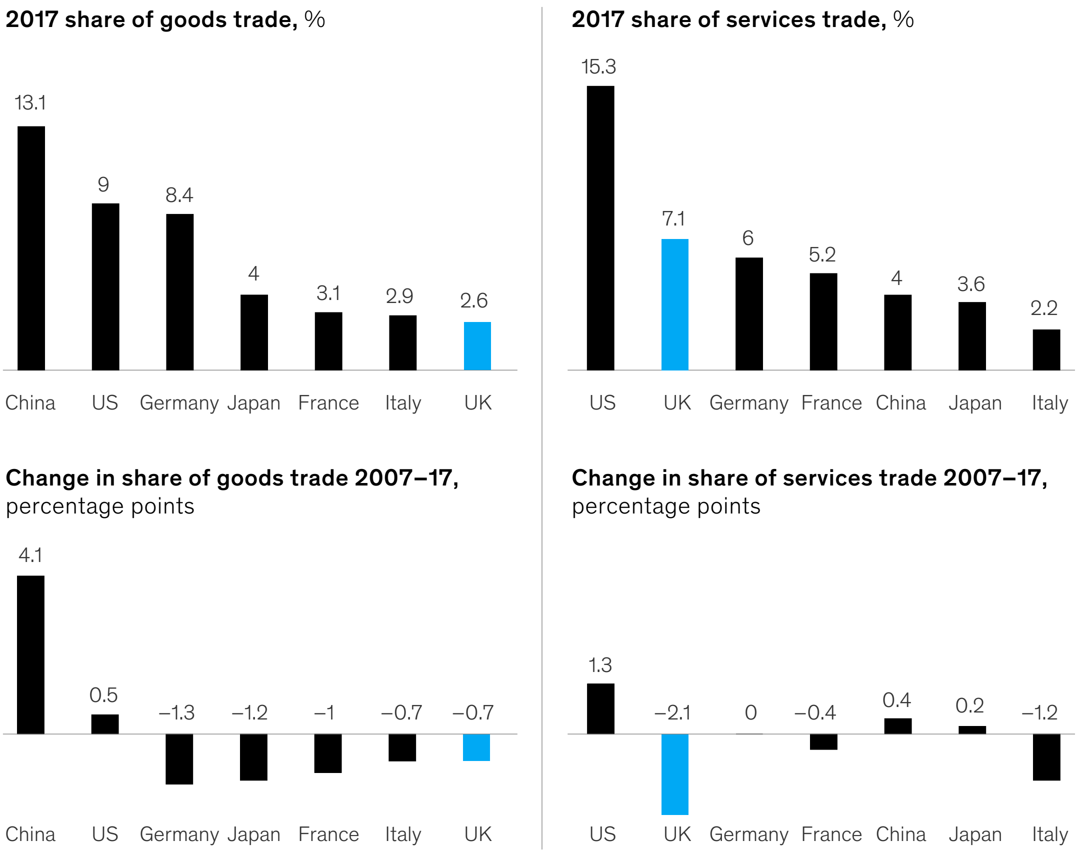
2017 composition of UK services exports, %



[1]Includes architecture, waste treatment, leasing, and trade-related services.
[2]Includes construction, maintenance, repair, and government services.
Source: *UK balance of payments, the Pink Book: 2018*, Office for National Statistics, July 2018, ons.gov.uk; McKinsey analysis

Exhibit 3

The United Kingdom has a large, but declining, share of global services trade



Source: International Monetary Fund; Organisation for Economic Co-operation and Development; United Nations Conference on Trade and Development; World Trade Organization; McKinsey Global Institute analysis

50%

The rise of emerging economies is radically reshaping global trade flows: emerging markets' share of global consumption has risen by roughly 50 percent over the past decade.

The big shifts underway in global trade

The rise of emerging economies is radically reshaping global trade flows: emerging markets' share of global consumption has risen by roughly 50 percent over the past decade. Yet as incomes increase in China and other emerging economies, these countries are consuming more of what they produce and exporting less. They are also producing more goods locally or regionally, rather than importing from developed economies. That has contributed to a decline in global trade in goods, which fell from 28 percent of global GDP in 2007 to 23 percent in 2017.

UK-based companies have struggled to build positions in the fast-growing emerging markets. The United Kingdom's share of total goods exports to developing economies is only 3 percent, in contrast with Germany's and the United States' shares, at 14 percent and 19 percent, respectively. As for China, only around 2 percent of value added in Chinese imports originates from the United Kingdom, while 5 percent comes from Germany and 12 percent comes from the United States.

UK companies' challenges in goods trade are not necessarily a barrier to the future success in exports, however, as global trade is increasingly turning to services and going digital.

The global market for traded services is growing more than 60 percent faster than goods trade. Some subsectors, including telecom, IT, and business services, are growing two to three times faster. In fact, global trade in services already exceeds that in goods when measured in value-added terms (and adjusted for cross-border flows of intellectual property to foreign affiliates and for cross-border flows of free digital services.) That trend presents important opportunities for the United Kingdom in emerging markets, as the services sector is less dependent on proximity to trading partners.

The United Kingdom is already one of the world's largest exporters of digitally delivered services.

In digital trade, a remarkable transformation is underway. Alibaba's AliResearch projects that cross-border B2C e-commerce alone will grow to approximately $1 trillion by 2020. Cross-border data flows have increased nearly 150-fold since 2005. Technologies such as additive manufacturing, digital platforms, the Internet of Things, automation, and artificial intelligence (AI) are also fundamentally changing the types of products and services that are traded, creating exciting opportunities for innovative companies.

The United Kingdom is already one of the world's largest exporters of digitally delivered services. For example, its exports of architectural, engineering, scientific and other technical services grew from around $5 to $15 billion between 1997 and 2017. There are plenty of success stories, such as Ryder Architecture. It has used digital platforms, such as building information modelling, to export UK architecture and design expertise to projects all over the world, especially in Asia. Another example is Arup, the UK-headquartered engineering company, which has used satellite imagery and AI to identify design hazards and export this analysis to sites across the world.

Yet it is not clear that UK-based businesses are taking full taking advantage of the technology revolution that promises to reshape global value chains.

In "Digital Europe: Realising the continent's potential," MGI estimated that the UK economy had captured 17 percent of its digitisation potential. While this is ahead of the United Kingdom's European peers, it lags behind China and the United States. While many UK companies have embraced customer-facing innovations, such as e-commerce, they have invested less in transforming end-to-end process efficiency. For example, only 12 percent of UK enterprises have adopted supply-chain-management software, compared with 30 percent in Germany.

100m

Over the next 15 years, China's working-age-consumer segment will expand by an additional 100 million people.

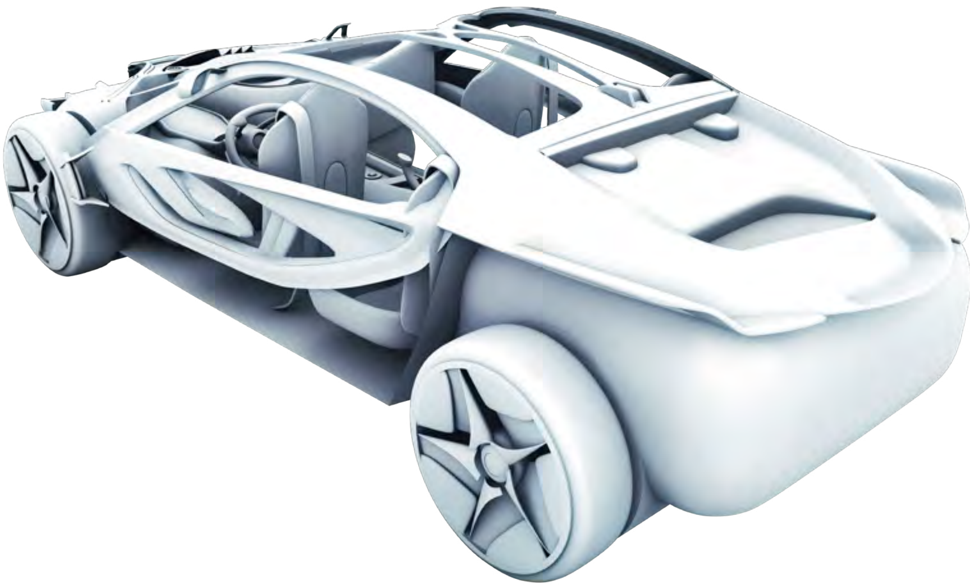
Three priorities for UK businesses

To unlock the United Kingdom's full potential in exports, there are certainly issues that the government and industry bodies will need to address—including skills gaps and infrastructure bottlenecks. But, as our analysis of UK productivity performance shows, much of the action needs to happen at the level of individual businesses. Whatever the outcome of Brexit, there are steps that UK companies can take now to embrace global megatrends and win in a rapidly changing world. Three stand out.

First, UK exporters need to *prioritise growth, speed to market, and proximity to customers*. With the economic center of gravity shifting east and south, businesses need to be present in the world's big growth markets. Over the next 15 years, China's working-age-consumer segment will expand by an additional 100 million people. The speed of innovation in the digital powerhouse that is China is both a challenge and an opportunity; companies require customer-centric operating models to succeed. For example, product managers responsible for developing new offerings need the authority to make decisions quickly and to hold staff from functional groups accountable

Second, UK companies need to make the most of *digital technology to optimise their supply chains*. By better capturing individual-customer data, companies can improve demand forecasts by up to 90 percent, minimising the cost of lost sales and customer disappointments. They can also reduce logistics costs by up to 30 percent—for example, by using dynamic routing, capacity-sharing platforms, autonomous vehicles, and 3-D printing. With advanced-systems support, they can automate as much as 90 percent of all planning tasks, delivering better quality compared with tasks performed manually. The same tools can dramatically reduce inventory needs.

Third, to respond to the rapidly changing environment, UK companies need to *become more agile* as a whole, beyond digitisation, customer centricity, and supply-chain optimisation. McKinsey research shows that the combination of speed and stability—the hallmark of agile businesses—is a significant catalyst for organisational health and performance. In a large-scale survey, respondents in agile units were 1.5 times more likely than others to report financial outperformance. The path to agility depends on the starting point, so the first step is to identify where the biggest pain points lie, and address these. However, in all cases, it will be necessary to put in place incentives to reinforce the new, agile behaviours.



Conclusion

UK businesses must embrace the new realities of world trade. They must act now to foster long-term growth and sharpen their competitiveness—regardless of the uncertainty about Brexit. The priorities are clear: get close to customers in new markets, harness technology to optimise supply chains, and embed agile practices throughout the organisation.

Tera Allas is a senior fellow and **David Chinn**, **Vivian Hunt**, and **Daniel Mikkelsen** are senior partners in McKinsey's London office.