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How to return Australia's wine industry to growth? Lessons from previous cycles

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The perfect storm of shocks that hit the Australian wine industry in recent years interrupted what had been the longest boom in its history.

The downturn in grape and wine prices has been blamed largely on the appreciation of the Australian dollar (AUD). If that was the only cause, then the AUD's depreciation over the past two-plus years should have lifted prices. Yet the export price in AUD has been flat during the past 4 years and, consistent with the correlation of the past three decades, so too has been the average grape price (Figure 1).

This suggests exchange rate changes are not the only reason for the decline in Australia's competitiveness since its exports peaked in 2007.

When expressed in US dollars, since 2001 the average wine export price has more than doubled for France and New Zealand, and almost doubled for the United States. Even for Chile it has risen 50% since 2003, despite their boom in copper export earnings. The US\$ export price for Australian wines, by contrast, has been on a slight downward trend for the past decade (Figure 2).

Evidently more will be needed than just the recent downturn in the AUD to restore profitability to the country's grape and wine producers.

What can we learn from earlier booms about how to return the industry to a growth trajectory that is sustainable and less vulnerable to yet another plateau?

A new book that brings together and analyses annual data since 1843 (Anderson 2015) provides an opportunity to address that question. Those data show that Australia's wine industry expanded throughout most of the past 17 decades but that, around that very long-run trend, there have been five distinct cycles of boom and plateau in vine area and wine production.

Those cycles are clearly seen when the vine bearing area is expressed as a percent of the country's total crop area. Each expansion of the bearing area of vineyards was rather rapid, but in each case it was followed by a longer period of decline. This index suggests that the industry has been losing competitiveness to other crops since the end of the 19th century (Figure 3). Even wine production has grown little when expressed per dollar of overall GDP, but that trend has been upwards because yields per hectare have risen thanks to an expanding share of vines being irrigated and to more grapes being used in recent decades for wine rather than other uses.

Only two of the four previous booms involved the industry becoming more outward-focused: the period just prior to the 1890s' depression, and the post-World War I period prior to the depression of the early 1930s (Figure 4).

The other two booms, 1855-71 and 1967-75, were driven almost entirely by domestic demand growth, generated by rapid immigration and income growth.

The earlier export booms

Both of the previous export-intensive cycles were partly induced by government support policies that led to surplus production. Exporting in those periods was thus more a means of disposing of a surplus than a source of sustainable growth.

National wine production at the start of the 20th century was three times its 1880 level. As it had grown faster than domestic demand, one-sixth of the newly federated country's wine production was being exported (as bulk full-bodied reds), albeit at low fob prices.

Following World War I, the vine area expanded rapidly again, encouraged by the subsidized settlement on farms of ex-servicemen, particularly in the newly developed Murrumbidgee Irrigation Area of NSW and along the Murray River. Annual output of wine more than doubled in the decade to 1925, leading to a glut especially of Doradillo grapes whose price fell by two-thirds in 1924.

The Australian Government decided to further assist producers in the newly planted areas in the form of a volumetric bounty on fortified wine exports. The export bounty almost doubled the price received by producers, which dampened domestic fortified wine sales at the same time as boosting production and exports of fortified wines.

Then in its June 1925 budget, the British Government introduced, by way of thanks for war contributions, tariff preferences for wines from the British Empire that effectively halved the duty paid by Australia in that market. Like the export bounty, the UK import duty was volumetric rather than ad valorem, thereby discriminating in favour of low-quality wines; and the UK preference was four times as great for fortified as for still wine, further depressing the incentive to produce quality still wines.

The industry continued to be assisted also during the interwar and early post-WWII period by import tariffs on wine and brandy, a sales tax of 15% on imported but not domestically produced wine, excise taxes on beer and spirits but not on wine, and a lower excise tax on brandy than on other spirits.

The import tax on wine was non-trivial, generating a rate of industry assistance that was above the average for other manufactures and twice the average for the agricultural sector. That helps explain both the low share of imported wine in domestic consumption and the relatively low level of wine consumption per capita up to the mid-1960s.

With returns to winemakers falling from the late 1920s, a vine-pull scheme by the South Australian Government was introduced in 1936. That contributed to two-thirds of the Coonawarra region's vines being uprooted. Meanwhile, in Victoria's Yarra Valley, farmers began turning to dairying; and in the Hunter Valley of New South Wales, the area of vines

was eventually halved. Hence the total vine area in Australia grew only by one-fifth between the mid-1920s and mid-1960s, and it was five decades before the annual volume of wine exports achieved in the late 1930s (artificially boosted to build stocks in Britain for the foreshadowed war) was again reached.

The export assistance in the interwar period was a mixed blessing at best: being confined to fortified wines it undermined the growing British and continental European interest in Australian dry table wines that had been slowly building up over the previous few decades; and, by being volumetric rather than *ad valorem*, the trade measures dampened the incentive to produce higher-quality wines.

In 1947 Britain raised its tariff on fortified wines five-fold (and kept it very high until the end of the 1950s) and the Australian government removed its wine export bounty. Britain hiked its tariff on fortified wines again in the late 1960s, and in 1973 it joined the European Economic Community which allowed duty-free access to Britain for wines from the other EEC member countries.

The Korean War-induced wool price boom and then subsidies to other farm products meant sheep, wheat, milk and tobacco production appealed more to farmers than winegrapes. As well, tighter import restrictions on other manufactured goods boosted the import-competing industrial sector, while the removal in the early 1960s of a ban on iron ore exports triggered a boom in mining exploration, both of which indirectly dampened producer incentives in other sectors including wine.

The 50% rise in wine consumption in the 1960s was helped by a one-third increase in real income per capita, by brand advertising and generic promotion domestically, by the influx of wine-preferring immigrants from southern Europe, and by many more young Australians travelling to Europe once cheap airfares for under-26-year-olds were introduced. (A symptom of the influence of southern Europeans on Australian preferences was the gradual transformation of non-alcoholic beverage consumption from 3 kgs of tea and 0.4 kgs of coffee per year in the early 1950s to 0.8 kgs of tea and 2.4 kgs of coffee by the late 1990s.)

A mining boom at home and spikes in energy raw material and food prices internationally in 1973-74 and again in 1979-80 reduced the competitiveness of Australia's producers of other tradables including wine. Wine exports remained flat from the mid-1960s to mid-1980s, wine exports to the UK shrunk by nine-tenths, and the value of wine imports exceeded that of exports during 1973-86. Grape and wine prices also remained low, particularly for reds.

Reforms of liquor licencing laws for restaurants and hotels, and the Trade Practices Act of 1974, made retail price fixing illegal and stimulated the emergence of liquor chain stores and wine discounting.

This period also saw the commercial development of the 2- to 4-litre cask, or 'wine in a box', which added hugely to domestic demand at the lower end of the market. Between 1978 and 1984 the volume of white wine sold in Australia in a plastic bag inside a box rose from 33 to 152 ML per year, while bottled red and white wine sales fell by one-quarter, from 73 to 55 ML.

Neither of the surges in production in the two decades to the mid-1980s, of first red and then white table wines, was export-driven. The industry continued to be internationally

uncompetitive and dependent on protective import restrictions on dried vine fruit, wine and brandy.

In 1984 the Government introduced a 10% wholesale sales tax on wine, and raised it to 20% two years later. That, plus the perceived over-supply situation especially in reds in the mid-1980s, meant the prospects for grapegrowers and winemakers looked bleak. It seemed inconceivable to many observers at that time that another boom was about to begin, so the South Australian and Federal governments co-financed a vine-pull scheme in 1985-86.

Features of the latest boom

The most-recent boom began in 1986 with a steady increase in exports to take advantage of the historically low value of the Australian dollar, which was due to a sharp fall in prices of Australia's coal, grain and other primary export products.

The export expansion was so large as to raise wine's share of total merchandise exports above the 0.9% record set in 1932, peaking in 2004 at 2.3%, just as mineral exports were taking off.

The wholesale value of Australian wine sales doubled between 1984-86 and 1992-94, and both the domestic consumer price and the export price of Australian wine grew by around 50% over that period. Those price changes stimulated vine plantings, wine production and wine exports, and slowed the growth in domestic sales of Australian wine (as did another increase in the wholesale sales tax on wine from 1993).

Grapegrowers were the main beneficiaries of the initial increase in Australian wine prices. The average price received for winegrapes was three times higher in 1999 than at the start of that decade, even though the export price rose only 60% (Figure 1).

While this fifth boom was largely market-driven, it was also influenced by changes in government interventions. The steady reduction in manufacturing protection and in assistance to some other agricultural industries, that began in 1972 and accelerated through the 1980s and 1990s, paralleled and thus offset the reductions in nominal rates of assistance to grape and wine producers.

The imposition from 1984 of the wholesale sales tax on wine dampened domestic sales but encouraged exporting, while the government's vine-pull scheme in the mid-1980s led to the loss of some valuable old vines but the replacement of others with more-profitable varieties.

By way of consolation for raising the wholesale sales tax again in 1993, the government assisted new plantings of vines by providing for accelerated depreciation of vineyard construction costs, which contributed to the trebling of the vineyard area during the most-recent boom.

That huge expansion in vineyard plantings inevitably led to a surge in winegrape production three or so years later. Stocks of wine ready for sale trebled in the ten years to 2005.

Meanwhile, as mooted by Smart (1994), several New World suppliers began to emulate the Australian export-led experience, leading to a growth spurt in their wine exports just a few

years behind Australia's. As well, several Old World suppliers and Argentina and Chile were expanding their exports because of rapidly declining domestic consumption.

Thus Australian exporters began to face increasing competition just as the historically low value of the Australian dollar began its unprecedented 12-year rise (of 75% in trade-weighted real terms) after 2001.

The AUD appreciation contributed greatly to the subsequent decline in the AUD price of Australia's wine exports. So while the volume of those exports continued to expand each year until 2007 before stabilizing, their value plummeted as the AUD continued to rise in the wake of the massive mining investment boom (Figure 1).

The decline in wine export prices saw a parallel (and hence proportionately larger) decline in winegrape prices after 2001, yet the bearing area of grapes continued to rise for another seven years. By 2011 the average winegrape price had returned to the same nominal level as in 1989 (Figure 1).

Domestic consumers benefitted from these developments: the retail price index for wine grew far less than the overall consumer price index every year of the past ten. That was despite the increased consumption of higher-priced imported wines, which grew dramatically from the turn of the century thanks to the AUD appreciation (from 3% to 15% in volume and from 5% to 20% in value of domestic sales).

A direct consequence of the wine and grape price collapse was that both vineyard and winery asset prices plummeted after 2007, with some vineyards selling for no more than unimproved land value. The collapse in asset values was partly because banks lost interest in financing the industry, and partly because listed corporations sought to shed their least-productive vineyard and winery assets to boost the rates of reported return on their remaining capital.

Was the optimism at the start of the latest boom warranted?

The latest boom differs from the earlier booms in several important respects that justified new optimism. First, it was overwhelmingly export-oriented, in contrast with the first and fourth booms. Second, it was mostly market-driven, in contrast to the third (inter-war) boom that evaporated once government export assistance measures were withdrawn. Third, the quality of wine output improved hugely relative to the cost of production and its price. Fourth, the aging of the population and the rapid growth in incomes in high and middle-income countries, at least up to the 2008 financial crisis, was boosting demand, as was the global spread of wine supermarketing.

As well, those contemplating new investments in Australia's wine industry at the end of the 20th century could be excused for not anticipating the rapidity with which other New World suppliers copied Australia's export-led growth model. Nor could those investors have anticipated the combination of an unprecedented 12-year rise from 2001 in the value of the AUD, the global financial crisis from 2008 which reduced wine demand and weakened the US dollar, Euro and Pound Sterling, and a long and widespread drought that stimulated major policy reforms affecting irrigation water availability and pricing.

How exceptional was the latest export growth spurt?

Certainly the latest boom raised the annual volume and value of wine exports and the share of wine production exported to levels far exceeding previous Australian records (Figure 4), and the length of this boom (21 years) is 50% longer than the first export boom in the late 19th century globalization wave and twice as long as the inter-war boom.

However, compared with wine export growth of other countries, the boom is not particularly exceptional. All other New World wine-producing countries grew the US\$ value of their wine exports faster than Australia in the first decade of this century, and they have been converging rapidly on Australia since 2008.

Together these trends mean that Australia's comparative advantage in wine has slipped substantially since the start of the new millennium. This is indicated by the share of wine in national merchandise exports divided by wine's share of global exports. For Australia, that index peaked at 15 in 2003 (when it was exceeded only by Moldova and Georgia) before falling to only one-quarter of that by 2013. By that indicator, Australia is now also below New Zealand, Chile, France, Portugal, Italy and Spain.

Can institutional and policy reforms re-boot growth?

Recovery from the Australian wine industry's immediate difficulties won't be easy, and may not be as quick as the resurgence from the slump preceding the export-led take-off in the mid-1980s, as major adjustments will be required by many participants. However, the latest boom was not triggered by export subsidies, unlike the inter-war export boom, nor by a surge in domestic demand as in the previous boom.

To the extent there is a willingness to continue to invest for the long term (rather than just focusing on quarterly returns to shareholders), and if the earlier spirit of collaboration and unity within the industry can be re-invigorated, a return to at least normal levels of profitability should be possible before long. But it will depend on rebuilding competitiveness in export markets, because growth in domestic sales will be sluggish (slowing income and population growth, anti-alcohol lobbying) even if there is some displacement of imports.

One adjustment already under way is in export marketing. The earlier emphasis in generic marketing on 'Brand Australia', of providing sunshine in a bottle, has switched to a marketing strategy that places far more emphasis on higher-quality wines and exploits the scope to differentiate through building regional, varietal and style reputations.

An even stronger focus on promoting the country's fine wine offering will be needed going forward, given the increasing competition from lower-wage Southern Hemisphere countries in the popular premium category. Chile may have already surpassed Australia in offering the world the best value wine in that category, so the emphasis needs to switch to make the world aware Australia also offers excellent value for money with its finer wines.

Getting that message across in not only Australia's traditional markets but also in Asia will require a larger budget than AGWA's predecessor organizations have had in the past, which

were trivial relative to the value of national production and the extent of expenditure by European competitors. In 2011-12, for example, Australia's expenditure on generic promotion was barely 0.7 cents per litre of wine produced. That same year, Bordeaux alone spent 3.3 cents per litre. The European Union supplements regional and national promotion expenditures of its member states, and during 2009-13 it provided 522 million Euros for wine promotion, the equivalent to 0.6 Australian cents per litre of EU wine produced. Moreover, that EU promotion expenditure is to be raised to 1156 million Euros for the period 2014-18 (European Court of Auditors 2014). That is around 1.3 cents per litre, or double the rate recently spent in Australia – and that is just the supplement from Brussels, which adds to what will be spent by national governments and EU wine regions themselves.

As for R&D, less than 1% of the value of grape and wine production has been invested in R&D in the past, despite the returns from such investments being very high. Returns in the next two decades are likely to be even higher, bearing in mind rapid marketplace changes (the need to produce better quality rather than quantity of grapes and wine) and long-term uncertainties such as climate change, water and other environmental policy reforms. Of course it is difficult to reach agreement to raise the R&D levy on producers, especially when profits are low, but Australia will struggle to keep at the technological frontier without doing so.

Wine consumer tax policy reform could contribute to the transition to higher-quality wine production. If Australia were to switch from an ad valorem to a volumetric tax, that would encourage the transition to finer wines while weakening the case by anti-alcohol lobbies and the beer and spirits producers for a higher *rate* of tax on wine. Such a switch would make it easier for small fine-wine producers to sell all their production on the domestic market, thereby avoiding the high fixed costs of breaking into new export markets. There is the risk that any change to the method of taxing wine consumers will be accompanied by a hike in the rate of taxation, but that could need to be countered by strengthening the argument that, since moderate wine consumption can have positive health and social externalities, its tax rate should be below that on other alcohols.

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Figure 1: Average AUD price of winegrapes and of exports, and vine bearing area, Australia, 1986 to 2014

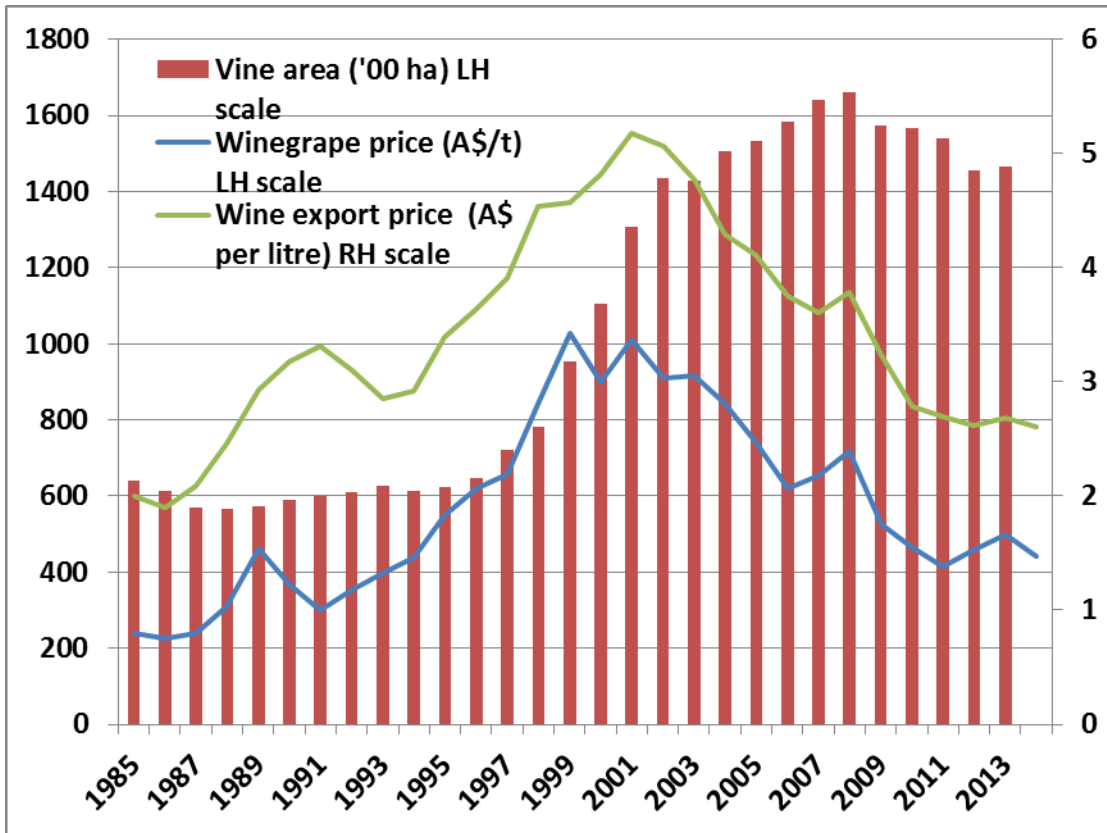


Figure 2: Unit value of wine exports, Australia and competitor countries, 1990 to 2014 (US\$ per litre)

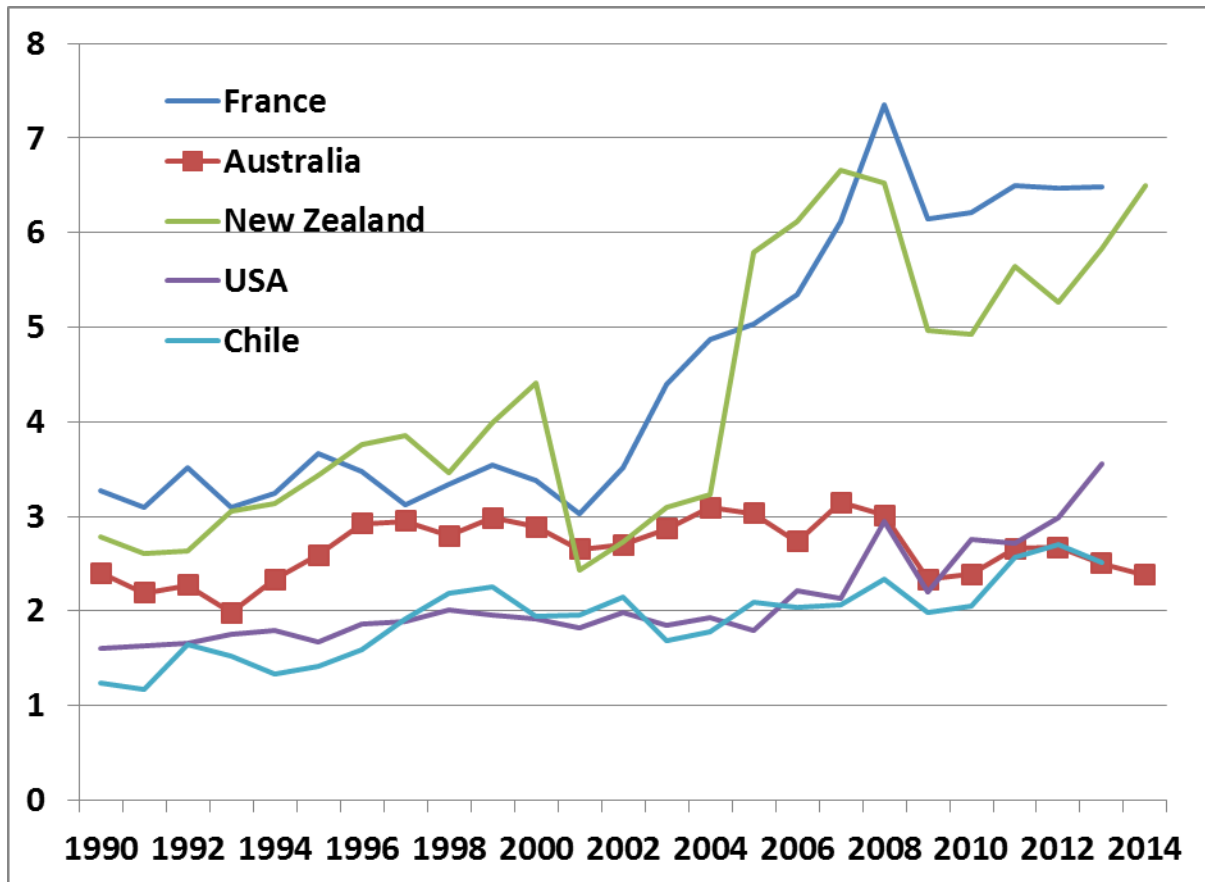


Figure 3: Vine bearing area per capita and wine production per \$ of GDP, Australia, 1843 to 2013 (2007 = 100)

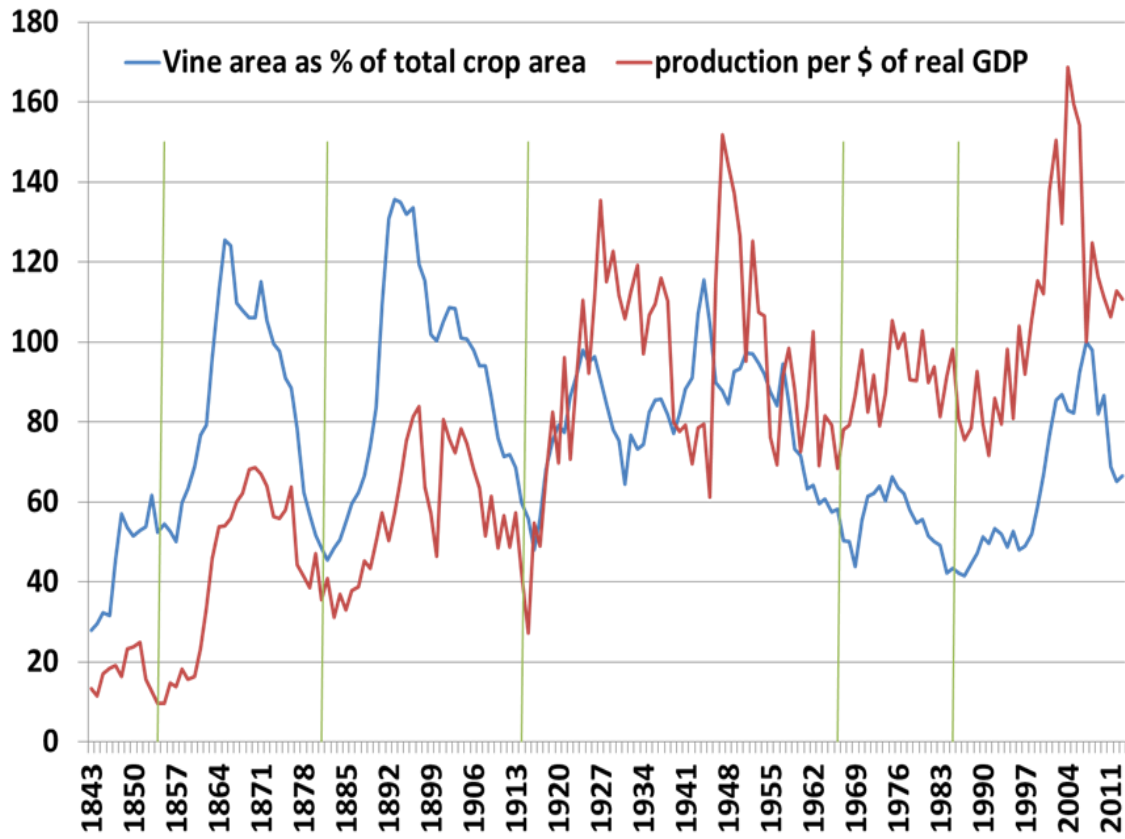


Figure 4: Exports as % of wine production and imports as % of apparent wine consumption, Australia, 1843 to 2013 (3-year moving average)

