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How will Brexit affect Australia's wine exports?

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How will Brexit affect Australia's wine exports?

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This Brief was prepared for the Institute for International Trade/Department of Foreign Affairs and Trade seminar on *BREXIT: Challenges and Opportunities for Australia,* University of Adelaide, 26 June 2017, and for a public hearing in Adelaide on 3 July 2017 for the JSCFADT Inquiry into Australia's Trade and Investment Relationship with the United Kingdom. It draws on a longer paper by the authors (Anderson and Wittwer 2017a), and on Briefing Paper 9 of the UK Trade Policy Observatory, University of Sussex (https://blogs.sussex.ac.uk/uktpo), following a presentation of the latter at the Royal Institute of International Affairs' Chatham House in London, 19 May 2017. The views expressed are the authors' alone.

Key points

- For wine markets, the initial impact of the UK leaving the EU Single Market is likely to come not only from tariff changes but also from slowed growth of UK incomes and devaluation of the pound.

- Even if the UK were to sign new trade agreements with the WTO, EU27 and others, the time it would take to implement them and for markets to adjust ensures that the initial effects of Brexit on wine markets will be adverse over the next few years, so in this study we project wine market to 2025 assuming in that period only the UK's WTO commitments are rectified.

- Our main modelling scenario suggests the UK consumer price of wine in 2025 will be one-fifth higher in local currency terms than it would be without Brexit, the volume of UK wine consumption will be 28% lower, and the volume and value of UK imports will be one-quarter lower because of Brexit.

- Thus even non-EU wine-exporters will sell less wine into the UK in 2025 because of Brexit.

- Global wine trade in 2025 will be less by 240 ML (1.9%) or $1.8 billion (3.5%) thanks to Brexit.

- Australia's wine exports to the UK in 2025 under Brexit will be 4 ML (2.5%) less, and the volume and value of its global exports of wine will be, respectively, 1% and 3% less.

- Australia can respond by seeking an Australia-UK FTA, but probably would not want to finalize it before the UK settles on its new trade commitments with the WTO membership and then with the EU27, and probably also not before the Australia-EU trade negotiations that began in November 2015 are completed.

- In the meantime, Australia should negotiate with the UK for an equivalent (or better) of the Wine Agreement it has with the EU28 on technical matters, and should encourage the UK to join the World Wine Trade Group.

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How will Brexit affect Australia's wine exports?

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Brexit negotiations between the UK and Brussels began shortly after the UK's June 2017 election, and are to be completed before the end of March 2019. According to Alasdair Smith (2017) there is no way a deep UK-EU27 free trade agreement (FTA) can be reached in 21 months. The options within that period are few. One is a 'hard Brexit', in which the UK would become completely independent of the EU (i.e., leave the Single Market) and adopt its own trade policy commitments by transposing the UK's current share of EU obligations to the WTO (World Trade Organization) into independent UK obligations.[1] Staying within the Single Market would require the UK to continue to allow freedom of movement of labour, to remain under the European Court of Justice, and to retain the EU's trade policy, none of which Brexiteers want. Another option is to join the EEA (European Economic Area), involving a relationship with the EU of the kind Norway has: largely tariff-free trade with the EU and full participation in the internal market, ***but also*** freedom of movement of labour to almost the same extent as for EU members. Since Brexiteers do not want the latter, and it appears the EU would not contemplate such an agreement without that clause, it would seem the only immediate choice, as Rollo et al. (2016) suggested at the outset, is for the UK to adopt the EU's tariff schedules previously agreed to at the WTO. Only when that is in place could FTA negotiations begin with the EU and other trading partners, including Australia. If those FTAs are to be 'deep', their negotiation will take years rather than months to complete, and their implementation will take several more years after that. And most non-EU countries would want to see the UK-EU27 FTA outcome – which will be the UK's highest priority since half its trade is with EU27 countries – before concluding their own bilateral FTA with the UK.

[1] Simple though that sounds, the UK's rights and obligations at the WTO will need to be negotiated with the WTOs' 164 members. That includes negotiating with the EU and its main trading partners on how the hundreds of tariff rate quotas (TRQs) on various agricultural products are to be divided between the UK and EU27, and similarly how TRQs faced by the EU in markets such as Japan are to be split.

What does that mean for trade in wine for countries such as Australia? To begin to answer that question, one needs to look beyond the immediate trade-reducing and trade-diverting effects of altering bilateral import tariffs. Not only is the process of exiting expected to take several years but also, in the interim, it is expected to slow the growth of UK incomes and devalue the pound. Indeed during the first 12 months after the Brexit vote the UK's trade weighted index of foreign exchange rates fell 9%, and average wages fell in the first half of 2017. Any projection of how wine markets will look in several years' time therefore needs to consider all three effects: altered bilateral tariffs on UK wine imports (and on its exports and re-exports to EU27), a lowering of UK real incomes, and a real devaluation of Sterling. We presented results from such a study at Chatham House in London last May, but with a focus on what it could mean for UK stakeholders (see Anderson and Wittwer 2017b). In this article we focus on the implications for Australia of the first stage of the Brexit transition with its adverse macroeconomic consequences prior to the restoration of investor confidence that is not expected until the UK establishes new trading agreements with the WTO and EU27.

Wine in the UK, and the UK's importance to Australia and other wine exporters

Over the past six decades, wine's share of UK alcohol consumption has risen steadily, from just one-twentieth to more than one-third. The UK is now the world's second-largest wine importer in terms of both volume (after Germany) and value (after the United States): its share of the value of world wine imports rose from around 10% in 1960 to above 20% in the early 2000s. By 2016 it had fallen back to 14% in both value and volume terms. Even so, the UK's share of global imports of wine is still more than three times the UK's importance in importing other goods.

The UK's importance to wine-exporting countries is clear from Figure 1. For seven key suppliers, the UK accounted for more than one-sixth of their wine export earnings during 2010-14. For three of them (Australia, the US and New Zealand), the UK was a market for more than one-third of their volume of wine exports in that half-decade. In 2016-17, the UK was the largest market for Australian wine exports by volume, with a 29% share, and third-largest by value with a 15% share.[2] Since only 4% of Australia's overall exports go to the UK, this market is nearly four times as important to exporters of wine as it is to Australia's

[2] The decline in the importance of the UK in the value of global wine imports is because of East Asia, whose share has trebled since 2003, from 7% to 21%. In 2016-17, East Asia was the destination for almost 20% by volume and 40% by value of Australia's wine exports.

other exporters. In recent years wine has been Australia's most (or 2nd or 3rd most) valuable item of export to the UK.

The share of Australia in UK wine import volumes has quadrupled since the early 1990s to around one-fifth, but the countries enjoying duty-free access to the UK market (EU27 members plus Chile and South Africa) still account for two-thirds of UK wine imports (Table 1).

Consequences of leaving a customs union

When countries join a customs union -- which abolishes tariffs on trade between them and imposes a common external tariff on imports from non-union countries -- there may or may not be net external trade creation, depending on the height of the common external tariff relative to the previous national tariffs. But there will also be trade diversion. This is because the preference to producers within the union means some imports from the rest of the world are displaced by imports from other union countries.

When a country leaves a customs union, the reverse happens: the leaving country's tariffs (once determined) will then apply to its imports from union countries as well as from the rest of the world. Hence even if the leaving country decides to have no tariff on a particular good, imports of that good from the union will fall, because their preferential access to the leaving country will no longer apply. That is also the case for countries that enjoyed a free trade agreement (FTA) with the union, which is of significance to wine because Chile currently has tariff-free access to the UK through its FTA with the EU, as does South Africa for a certain volume of its wine imports.

The extent of the reversal of external trade creation and trade diversion on wine depends on the size of the external tariff imposed on wine imports by the union and the tariff chosen by the leaving country. Some have suggested the UK should become the Hong Kong of Europe and go immediately to free trade in all products. This is considered by most people as politically unlikely, however, as it would impose huge structural changes on the UK economy which would be intolerable without major compensation packages.

Modelling Brexit's impact on global wine markets to 2025

To estimate the possible impacts of Brexit on wine trade, we make use of the authors' model of the world's wine markets (Anderson and Wittwer 2013). That model disaggregates those markets into non-premium, commercial-premium and super-premium still wines, plus sparkling wine. Each of those four types of wines of each country are imperfect substitutes for wines from all other countries. The model also divides the world into 44 individual nations and 7 composite geographic regions that capture all other countries. The model's database is calibrated to 2014 and projected forward to 2025 assuming aggregate national consumption, population, and real exchange rates change to the extent shown in Anderson and Wittwer (2017, Appendix Table 1). This provides a baseline in 2025 assuming the Brexit vote went the other way (for the UK to remain in the EU). That baseline can then be compared with alternative scenarios depicting the effects of Brexit.

Given that a new UK trade policy which sets most-favoured-nation tariff rates will be needed before the UK can begin to negotiate new FTAs with the EU27, its current FTA partners such as Chile and South Africa, or other countries such as Australia, we assume – following Rollo et al. (2016) – that the UK will adopt the EU's tariff schedules previously agreed to at the WTO and applied by the EU.[3] Since implementation of any subsequently negotiated FTAs is unlikely to be felt before 2025, we also assume the Brexit decision means the UK's per capita income growth rate will be only one-third as fast as it otherwise would have been to 2025, and that the fall in the value of the pound against the US dollar since 2014 will not recover before 2025.

These assumed adverse macroeconomic effects are more modest than many forecasts; but some analysts are less pessimistic, and so we compare those results with macro effects that are only half as large. In each case those adverse effects will add to the impact of tariff changes on aggregate wine consumption in the UK and hence on its bilateral trades in wine, making the loss of sales to the UK by EU (and Chilean and South African) suppliers greater than they would be if the only impact was from the tariff changes. Moreover, they reduce the likelihood that other countries' sales of wine in the UK will be higher than if Brexit didn't happen. Indeed, the adverse macro effects could outweigh the trade-diverting effects, so that even countries that are currently discriminated against by the EU28's wine trade policy may be worse off because of Brexit.

Specifically, the two Brexit alternative scenarios to the 2025 baseline that we consider below (named 'large' and 'small') assume that the rate of UK economic growth slows to

[3] The EU's applied tariffs are volumetric, but are currently well below the WTO-bound rate of 32%. We assume here that the UK would adopt the EU's current applied rates. We may therefore be understating the potential negative effect of Brexit on UK wine imports, as the UK government may come under pressure from domestic beer and spirits interests to apply higher than present tariffs on wine.

either 0.9% or 1.8% instead of 2.6% per year, and that the UK pound in 2025 will be 20% or 10% lower in real terms than it otherwise would have been in 2025. We also assume in both the ‘large’ and ‘small’ scenarios that the UK will apply the EU’s external tariffs on wine to imports from EU member countries (and Chile and South Africa), and that the UK will not have enough time by 2025 to negotiate and implement any new FTAs.

Results

Non-EU wine exporters might expect to gain from Brexit by being able to export to the UK on the same terms as EU27 exporters (and also Chilean and South African exporters who have had preferential access to all EU28 markets). But three things need to be kept in mind. One is that the average wine tariff on non-EU imports into the UK currently is only about 13 pence per litre,[4] which is minor compared with the UK’s weighted average wine excise duty of almost £3 per litre and the 20% VAT. Secondly, if UK incomes grow slower, so too will consumption of goods such as wine. And thirdly, if the pound is lower because of Brexit, the price of imported goods will be higher in local currency terms, further dampening wine sales in the UK.

In our ‘large’ Brexit scenario, as compared with the initial baseline scenario, the average consumer price of wine in 2025 would be 22% higher in the UK in local currency terms (20% because of real depreciation of the pound, 4% because of the new tariffs on EU, Chilean and South African wines, and -2% because of slower UK income growth). The volume of UK wine consumption would be 28% lower (16% because of slower UK economic growth, 7% because of real depreciation of the pound, and 5% because of the new tariffs). Super-premium still wine sales would be the most affected, dropping by two-fifths, while sparkling and commercial wines would drop by a little less than a quarter. Since the average price rises by less than the fall in the volume sold, the aggregate value of UK sales – even in local currency terms – would fall under this ‘large’ Brexit scenario. It would fall also under the ‘small’ Brexit scenario (with just half the assumed shocks to incomes and the pound): in that case the average consumer price of wine in 2025 would be 11% higher in the UK and the volume of UK wine consumption would be 17% lower.

[4] This is a weighted average: the wine tariff is larger the higher the alcohol content, and is higher for bottled than for bulk wine.

The volume of projected UK imports in 2025 is 427 million litres (ML) less, or nearly one-quarter lower, in the ‘large’ scenario than in the baseline scenario. The reduction involves 58 ML less sparkling, 31 ML less super-premium still wine, and 339 ML less commercial wine. World imports would be lower by just 240 ML because imports by other countries would be 187 ML higher in response to the international prices of wines being lower in this ‘large’ scenario. In value terms UK imports are $1.75 billion (or 27%) lower in 2025 because of ‘large’ Brexit: $1.13 billion because of lower incomes, $0.38 billion because of the fall in the pound, and $0.14 billion because of the rise in wine import tariffs. These aggregate trade impacts are just over half as large in the ‘small’ Brexit scenario (Table 2).

Without Brexit, the UK’s share of global wine imports would have been slightly higher in volume terms in 2025 than in 2010-15, but 2 percentage points lower in value terms thanks to East Asia’s expanding demand for imports of premium wines. With ‘large’ Brexit, however, that value share would be a further 2 percentage points lower, and the volume share would be almost 5 points lower (Figure 2). The net effect of these impacts on global trade are shown in Figure 3: most of the wine trade effect of Brexit is a large decline in net imports by the UK with very little offsetting positive effect on trade in the rest of the world. The ‘small’ Brexit scenario numbers are just over half of those in the ‘large’ Brexit scenario.

Table 3 reveals that European, Chilean and South African wine exports are significantly lowered by ‘large’ Brexit (by 151 ML or US$1.2 billion in the case of the EU), with some of their exports diverted from the UK to EU27 and other markets in competition with New World exporters. While the US, Australia, Argentina and New Zealand sell only a little less into the UK, they sell less also to other countries because of the sales by the EU27, Chile and South Africa being diverted from the UK. For Chile and South Africa, who lose their preferential access to UK (but not to EU27) markets in this Brexit scenario, some of their exports are re-directed from the UK to EU27 countries but again they export less overall. Global wine trade in 2025 would be less under Brexit by 240 ML (1.9%) or $1.8 billion (3.5%).

Table 3 suggests that Australia would sell slightly more to the UK in the ‘small’ Brexit scenario, but slightly less in the ‘large’ Brexit case. Evidently, the negative income and pound devaluation effects in the ‘small’ scenario do not more than offset the positive trade-diverting effect of removing the current EU discrimination against Australian (and other non-EU) exports to the UK, unlike in the ‘large’ scenario.

How much difference Brexit would make to the growth in Australia’s bilateral trades in wine between 2014 and 2025 are shown for the ‘large’ scenario in Figure 4. In volume terms (Figure 4(a)), Australia's exports to the UK are projected to change hardly at all by 2025 had the Brexit vote gone the other way, whereas with 'large' Brexit the projected volume is 4ML (2.5%) less than in 2014 and less than what otherwise would have been the case in 2025. The value of that bilateral trade would be 6% (US$25m) less in 2025 thanks to Brexit. The 2025 volume of exports from Australia to the rest of Europe is projected to be less with or without Brexit, but lower under Brexit because of increased competition from European wine exports diverted from the UK. Australia is also expected to sell less to Canada and New Zealand in 2025, because of substantial market growth in the US and especially Asia, with Brexit making little difference to those bilateral trade volumes.

Because our baseline scenario captures the on-going upgrading of wine consumer preferences in all markets, the value of Australia's trade to all key markets rises in real US dollar terms between 2014 and 2025 – but to the UK it rises only half as much in the Brexit case (Figure 4(b)). Indeed it rises less to each of Australia's key markets under Brexit, the overall reduction in value due to Brexit being 3%.

Conclusion

The above model results suggest Brexit will be costly to UK consumers of wine (and of many other products) assuming the UK initially adopts the same tariff schedule in the WTO as the EU and that it takes several years before the uncertainly associated with the UK's forthcoming trade arrangements with the EU27 and other trading partners is reduced. In the 'large' Brexit scenario, the volume of wine consumed in the UK in 2025 will be lower by more than one-quarter, and even in the 'small' scenario it will be lower by one-sixth. That will be a blow to many participants in UK wine bottling, transporting, storing, wholesaling and retailing businesses, in addition to restaurants and pubs.

Wine consumers in countries other than the UK are slightly better off during the Brexit transition, but only to the extent of an average reduction of 1.6% in the local currency price of the wines they purchase and an expansion of around 1.0% in the volume of wine they would consume in 2025 in the 'large' scenario (or about half those magnitudes in the 'small' case). Overall, worldwide wine production and consumption are slightly less under the 'large' and 'small' Brexit scenarios (below 1% less for Australia), as one should expect with a rise in protectionism: gains to non-UK consumers are more than outweighed by losses to UK consumers and non-UK producers unless and until new trading relationships between the UK and major wine-exporting countries are agreed and implemented.

Of course the above Brexit simulations are just two of many scenarios that could be explored, and they relate only to the beginning of the Brexit transition. Once commitments with the WTO membership are settled the UK will seek a free trade agreement (FTA) if not a customs union with the EU27, and then look to conclude FTAs with other trading partners including Australia but also Chile and South Africa. Even if the UK were able to sign new FTAs, get them ratified (with 27 national and several regional parliaments in the case of EU27), and begin implementing them before 2025, however, it would make very little difference to the above 'large' or 'small' scenario results (since wine tariffs are a minor contributor to them) unless those FTAs were to reverse before 2025 our assumed downturns in UK economic growth and the value of the pound.

What can Australia do during this transition? It could begin to seek a bilateral FTA with the UK, but presumably would not want to conclude it before the UK settles new trade commitments at the WTO and with the EU27. Australia may also be better off first completing the Australia-EU FTA process that began in November 2015 (http://dfat.gov.au/trade/agreements/aeufta/Pages/aeufta.aspx). This is because Australia trades much more with the EU27 than with the UK: two-way goods and services trade in 2016 with the EU27 was 10.3% of Australia's total trade, while the UK's share was just 4.3%. Australia has an interest in the tariff that will apply to exports of wine from the UK to EU27 countries, since half the value and 80% of the volume of wine shipped from Australia to the UK is in bulk containers and is bottled in the UK, and some of those bottles are then re-exported to other EU countries. The EU27 may well agree to restore a zero tariff on such shipments from the UK, but presumably only if the UK sets a zero tariff on the EU27's wine exports to the UK – thereby returning to the current intra-EU28 preferential situation.

Meanwhile, Australia needs to negotiate with the UK for an equivalent to the hard-fought technical agreement between Australia and the EU28 on trade in wine (or ideally a more liberal form of that Wine Agreement, which was first signed in 1994 but was re-negotiated in 2008 and implemented in its revised form from September 2010). Also, Australia should encourage the UK to join the World Wine Trade Group (http://www.wwtg-gmcv.org/), which aims to facilitate international trade in wine through information sharing, discussion of regulatory issues in wine markets, and joint actions for the removal of trade barriers. Ultimately, Australia may end up with a better wine trading relationship with the UK than it has currently, but not for several years, during which time (see Figure 4) Asian wine markets are likely to have become even more important to Australian exporters.

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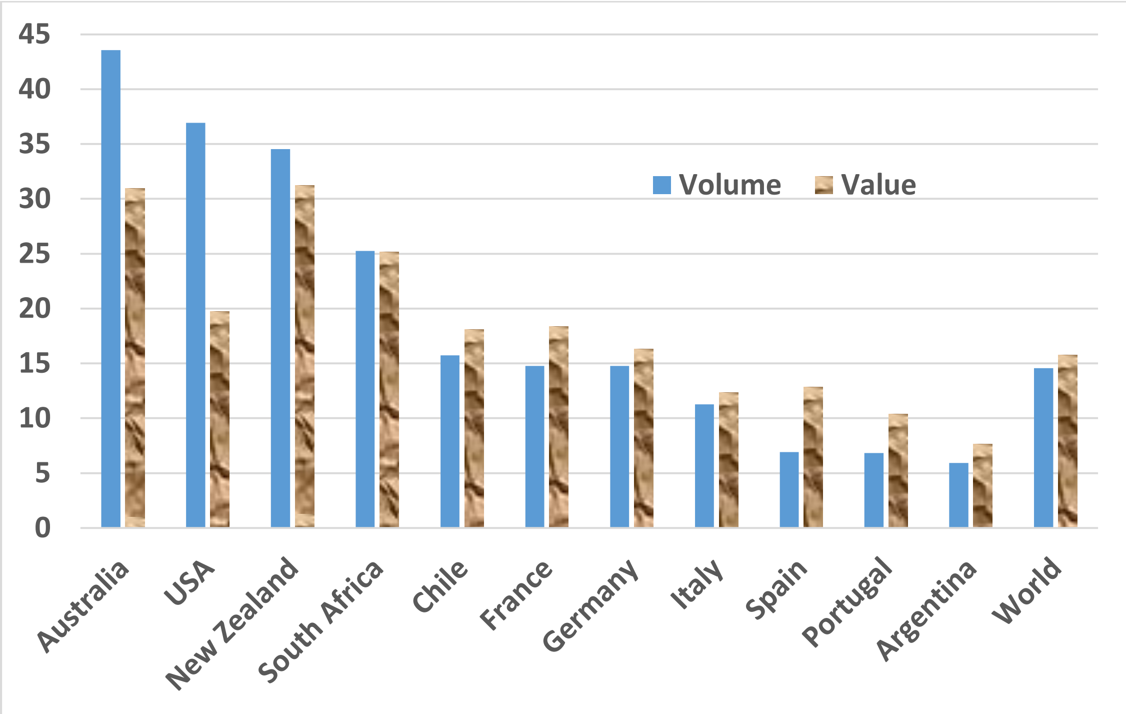
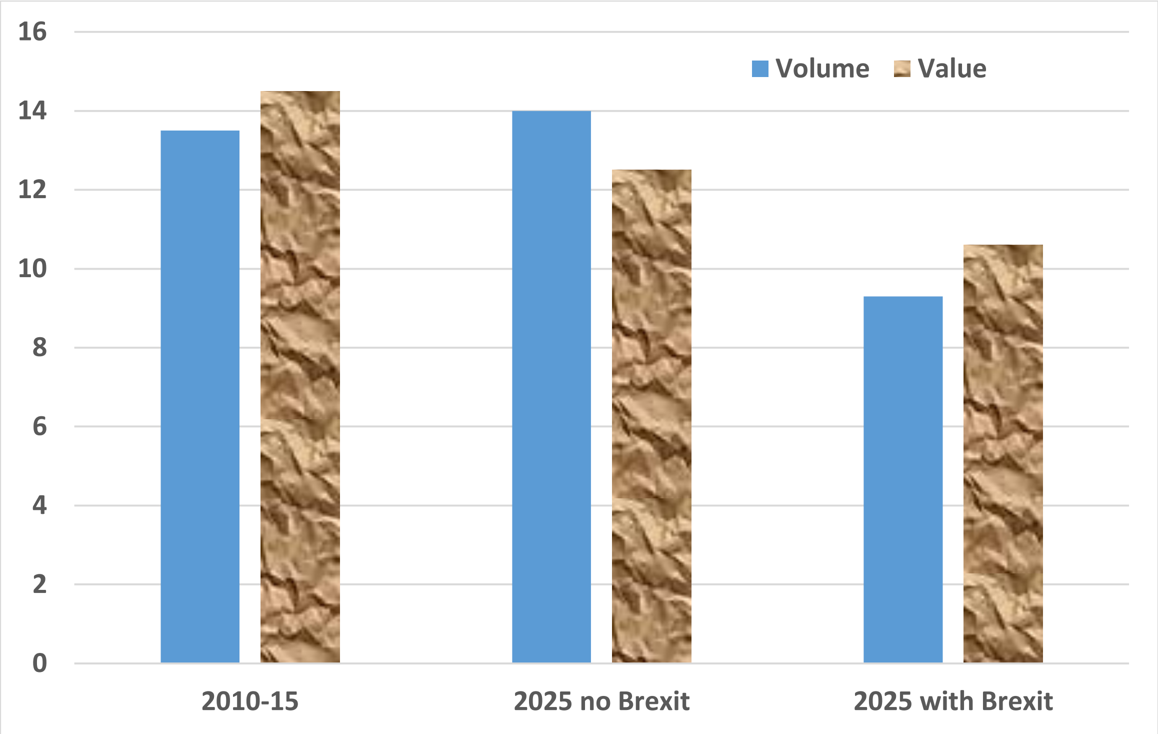
Figure 1: Shares of UK in wine exports of key wine-exporting countries, 2010-14 (%)



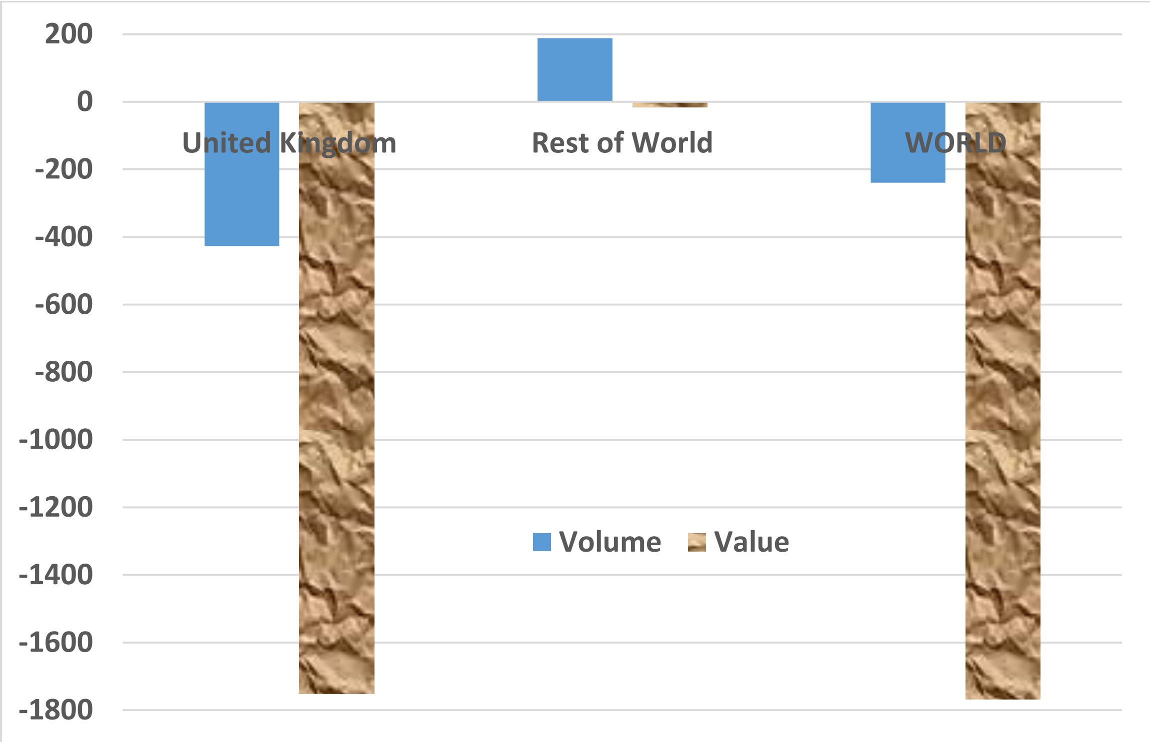
Source: Compiled from data in Anderson and Pinilla (2017).

Figure 2: UK shares of world wine imports, 2010-15 and projected to 2025 without and with Brexit 'large' scenario (%)



Source: Anderson and Pinilla (2017) and authors' model results.

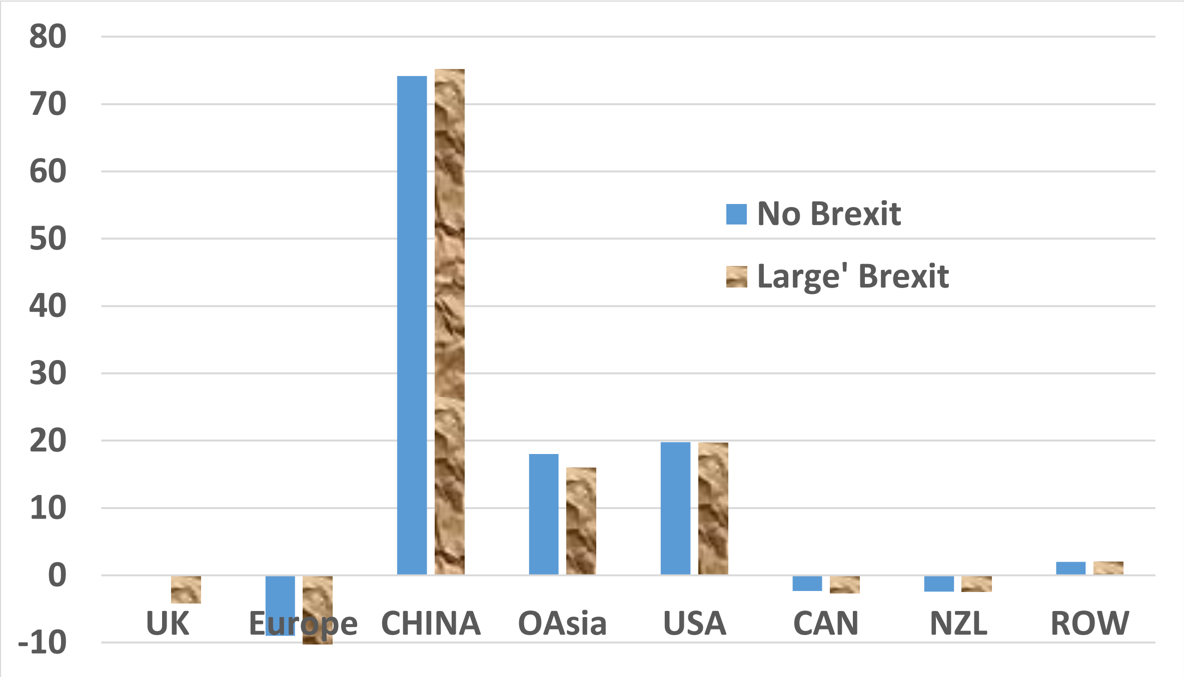
Figure 3: Difference in 2025 wine import volumes and values as a result of Brexit ‘large’ scenario (ML and $million in 2014 US dollars)



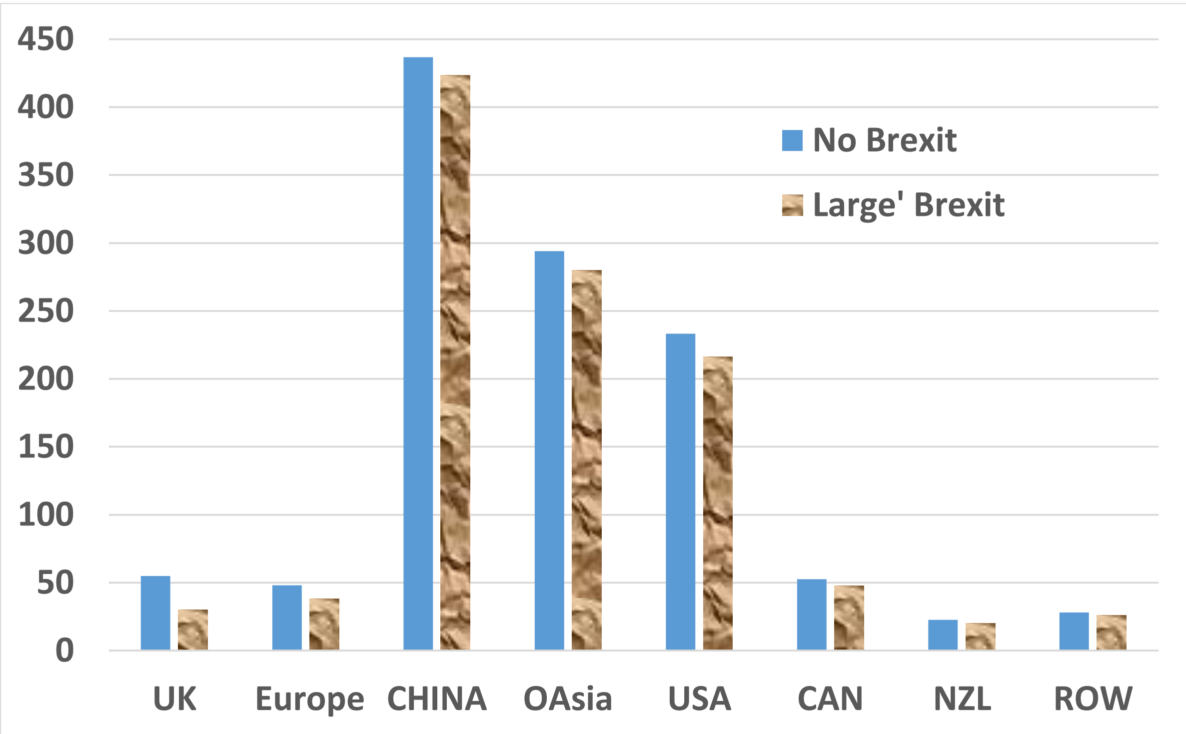
Source: Authors’ model results.

Figure 4: Change in Australia's wine export volumes and values between 2014 and 2025, without and with Brexit's 'large' scenario (ML and $million in 2014 US dollars)

(a) Change in volumes (ML)



(b) Change in values ($million in 2014 US dollars)



Source: Authors' model results.

Table 1: Share of UK wine import volume by source, 1990 to 2014, and projected in 2025 without Brexit (%)

	EU27	South Africa + Chile	Australia + New Zealand	United States	Others
1990-95	90	3	5	2	0
1996-01	68	10	16	6	0
2002-12	55	15	20	9	1
2013-14	52	15	21	9	3
2025 projected	63	16	13	5	3

Source: UN COMTRADE.

Table 2: Difference in 2025 projected volume and value of wine imports by the United Kingdom and the rest of the world as a consequence of Brexit (ML and 2014US$ million, 'large' scenario)

	Volume (ML)					Value (US$ million)				
	NP + CP[a]	Super Pr[b]	Sparkling	TOTAL	*%*	NP + CP[a]	Super Pr[b]	Sparkling	TOTAL	*%*
ΔUK imports due to:										
Lower incomes	-198	-20	-29	-247	*58*	-636	-253	-232	-1121	*65*
Lower pound	-70	-10	-14	-93	*22*	-256	-126	-105	-488	*27*
Higher tariffs	-71	-1	-16	-87	*20*	-110	-9	-25	-143	*8*
TOTAL	**-338**	**-31**	**-58**	**-427**	*100*	**-1002**	**-388**	**-362**	**-1752**	*100*
% diff. from base	*23*	*32*	*33*	*25*		*24*	*32*	*32*	*27*	
% of total cuts	*79*	*7*	*14*	*100*		*57*	*22*	*21*	*100*	
ΔROW net imports	143	21	24	187		23	142	-181	-16	
ΔWORLD TRADE	**-196**	**-10**	**-34**	**-240**		**-978**	**-246**	**-543**	**-1768**	

[a] Non-premium plus Commercial Premium still wines [b] Super-premium still wines

Source: Authors' model results.

Table 3: Difference in 2025 bilateral wine import volumes and values from key exporters by the UK and rest of the world (RoW) as a result of Brexit (ML and 2014US$ million)[a]

(a) 'large' scenario

	Volume (ML)				Value (US$m)			
	UK	RoW	WORLD	(%)	UK	RoW	WORLD	(%)
EU27	-284	133	-151	(-1.7)	-1182	-217	-1399	(-3.8)
Chile	-59	35	-24	(-3.0)	-170	31	-139	(-11.2)
SouthAfrica	-53	35	-18	(-3.2)	-106	20	-86	(-7.0)
Australia	***-4***	***-3***	***-7***	***(-0.9)***	***-25***	***-59***	***-84***	***(-2.8)***
Argentina	-3	-9	-12	(-4.8)	-16	-38	-54	(-5.1)
NewZealand	-11	9	-2	(-0.9)	-162	71	-91	(-4.3)
USA	-7	-6	-13	(-2.4)	-75	-39	-114	(-4.9)
Others	-11	-2	-13	(-0.2)	-16	215	199	(3.7)
WORLD	**-432**	**192**	**-240**	**(-1.9)**	**-1752**	**-16**	**-1768**	**(-3.4)**

(b) 'small' scenario

	Volume (ML)				Value (US$m)			
	UK	RoW	WORLD	(%)	UK	RoW	WORLD	(%)
EU27	-178	82	-96	(-1.2)	-692	-114	-806	(-2.3)
Chile	-46	28	-18	(-2.4)	-128	36	-92	(-3.5)
SouthAfrica	-43	29	-14	(-4.2)	-83	23	-60	(-5.1)
Australia	***5***	***-10***	***-5***	***(-0.6)***	***19***	***-52***	***-33***	***(-1.2)***
Argentina	0	-6	-6	(-2.6)	-3	-25	-28	(-2.9)
NewZealand	-5	4	-1	(-0.6)	-80	34	-46	(-2.3)
USA	1	-6	-5	(-1.1)	-23	-27	-50	(-2.3)
Others	0	-9	-9	(-0.1)	-1	93	92	(1.5)
WORLD	**-266**	**112**	**-154**	**(-1.3)**	**-990**	**-32**	**-1022**	**(-2.0)**

[a] Numbers in parentheses are the percentage difference between the Brexit and baseline scenarios for 2025 projected wine import volumes or values by source.

Source: Authors' model results.