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The other oil price: the problem with palm oil

Summary

The price of palm oil tumbled to a 6 year low in August, dragging with it shares in major palm oil producers and traders including Wilmar, Olam and Golden Agri Resources. Some analysts argue that palm oil is merely going through a standard commodity cycle, with a temporary glut causing a short-term fall in the price. However, two intrinsic problems with palm oil – its substitutability and difficulties with sustainability – are perennial headaches for the industry and becoming increasingly difficult for investors to ignore. Attempts by concerned governments to protect what may be a strategically important industry from this dynamic may yield short-term relief for the industry but exacerbate the problem in the long-run. This GCI explains why.

Palm oil is the most consumed and most widely traded vegetable oil in the world. Global demand has tripled in the last fifteen years, from around 20 million tonnes in 2000 to 60 million in 2014. Over half of the everyday goods on supermarket shelves contain palm oil: it is used in everything from lipstick to ice cream. Global supply is concentrated in just two countries: over 85% of palm oil comes from Indonesia and Malaysia. This high degree of concentration makes palm oil a different kind of commodity from petroleum, arguably even more exposed to political and policy risk.

Palm oil prices hit a 6-year low at the end of August, a fall of 60% since their peak in February 2011. Malaysian palm oil futures fell from a peak of $1,250 per tonne in February 2011 to $484 per tonne in August 2015. Palm oil's use as biofuel has pulled down its price alongside oil, whilst bumper crops of sunflower oil in Ukraine and Russia and soybeans in the US have driven prices even lower in the last few months.

The falling price has been reflected in the equity prices of major palm oil producers and traders. Shares in Wilmar International have lost 25% of their value since May, despite a series of intensive share buybacks. Shares in Golden Agri Resources have fallen by over 30% in the same period. This poor performance follows a year which had seen record profits for palm oil companies. On the back of increased production and high prices, many producers saw net profits rise up to sevenfold in 2014. What is the cause of this sudden reversal in fortune?

It is tempting to interpret the price crash purely in terms of commodity market dynamics. Record prices for palm oil in 2011 drove rapid expansion of palm plantations in Southeast Asia and West Africa. Oil palm takes three years to bear fruit, so those new plantations are just now coming on stream. This has resulted in a surge of supply since the end of 2014, at a time when growth in global demand was beginning to weaken. The major factors in this are slowing growth in China and India which combined represent 25% of global consumption. Sluggish economic conditions in the EU, which makes up another 10%, have also taken a toll on demand.

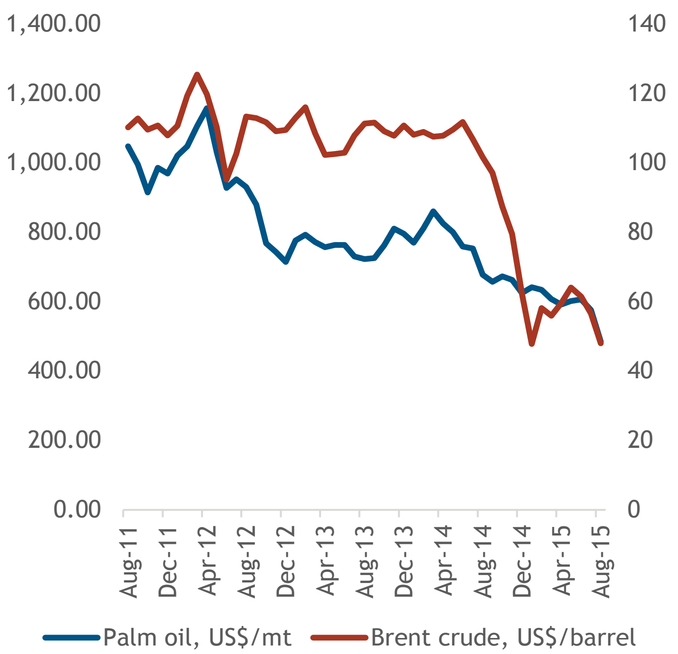

Figure 1: Palm Oil Prices
Source: World Bank and EIA

Sustainability and substitutability

Yet the short-term cyclical glut is not the only reason for the depressed price. Two issues in particular are set to exert downward pressure on the price over the long-term: growing concern about palm oil's environmental sustainability and its inherently high degree of substitutability.

Palm oil comes from a tropical plant that can only be grown within 10 degrees north or south of the equator, a band of global geography that also houses most of the world's remaining tropical rainforests. The oil palm plant is easy to grow, land efficient and profitable even at small scale -the main reason why almost every bit of available land in places like Sumatra have been cleared by villages and farmers for oil palm cultivation. The income for smallholder farmers of oil palm are several times that of rubber, rice or cassava. For exactly this reason, many countries in West Africa have been wooing palm oil companies and the opportunities they bring. The flipside of this is deforestation on a massive and massively damaging scale.

There have been efforts, driven initially by NGOs and subsequently embraced by Western consumer goods companies, to produce palm oil more sustainably. The 'Roundtable on Sustainable Palm Oil' (RSPO) formed in 2003 now has over a thousand members including producers, buyers, financiers and NGOs. Members engage in intensive debates over what it means to produce 'sustainable' palm oil. They are far from reaching a consensus: producers tend to complain that the standards are too tough, and buyers and NGOs criticism them for not being tough enough.

There is a growing expectation that producers and traders need to subscribe to this sustainability 'club'. Companies who are outside of it have been the subject of extended NGO campaigns although there is some space to curb the attention of campaigns through other measures. For example, a number of the more progressive Indonesian palm oil companies signed up last year to their own pledge outside the RSPO to curtail plantation development on land deemed to contain 'high carbon stock', including peatland. Banks including HSBC, Santander and Standard Chartered have all disinvested in recent years from companies accused by NGOs of being involved in deforestation in Indonesia and Malaysia, as has Norway's sovereign wealth fund, whilst Europe has seen the rise of the 'palm oil free' movement.

This rising tide of expectations around sustainability would be less of a concern for the industry if palm oil was not easily substitutable. The growing regime of audits and sustainability requirements, alongside the reputational issues, is challenging palm oil's position as the cheap and easy choice amongst vegetable oils. This is palm oil's USP: buyers in emerging markets such as China, India and Nigeria do not choose palm oil for the flavour but because it is cheap.

Meanwhile, bumper crops of US soy and Ukrainian and Russian sunflower oil have made them price competitive with palm, and these oils do not come with the same baggage. Furthermore, biotech companies in the US and elsewhere are working to develop new vegetable oils produced by algae that can mimic all the desirable qualities of palm oil whilst being even more land efficient. More importantly, production would not be constrained to tropical forest regions. Consumer goods companies are already investing R&D funds in these products, and once they become price competitive, the implications for palm oil will be profound.

Propping up prices with policy

States with vested interests in the palm oil industry are trying to take action to stem the falling price. Malaysia has launched a replanting programme, replacing old trees with new ones in an attempt to clear out the surplus of existing stock. The government is also spearheading efforts to open up new markets for palm oil in Iran, Turkey, Kazakhstan and Turkmenistan. Malaysian producers have also tried to navigate sustainability challenges by making moves within the RSPO to redefine sustainability criteria in order to open up more land for plantation. Some producers and states have also been working with NGOs to develop a 'jurisdictional approach' to sustainability, whereby a whole state would be certified rather than individual plantations.

Indonesia's approach to protecting what is a strategically important industry has been less conciliatory and more interventionist. With a value of over US$20 billion per year, palm oil is the third most valuable Indonesian export after petroleum and coal. The industry is thought to employ around 3.7 million people, and 25% of the individuals in Forbes' Indonesia rich list have made their fortune at least partly through palm oil.

There has always been a view within the Indonesian government that sustainability standards were at heart an expression of European 'green' colonialism. Recent weeks have seen an escalation in the backlash against the sustainability movement, with senior government spokespeople coming out to criticise the sustainability pledge signed by Indonesian producers and traders as unconstitutional and a breach of Indonesia's sovereignty. After a decade long implementation process for the EU-demanded timber export standards, the patience for permitting foreign interests to dictate agricultural policy in Jakarta is wearing thin, and is in any case out of step with the Jokowi administration's economically nationalist instincts.

More significantly, the government has in the last year intervened directly in the market to boost demand and to prop up the price. In 2013, legislation was introduced to impose a 10% minimum biofuel content for diesel; this was increased to 15% in April this year. The government also started paying subsidies for biodiesel at a rate of IDR 4,000 (30 cents) per litre, three times the previous level, in order to make it competitive with regular diesel. The subsidy was in theory funded by a US$50/barrel levy on exports of CPO, to be collected and managed by a new palm oil fund set up under the Ministry of Finance and headed by former Vice Minister of Trade Bayu Krisnamurthi.

As well as paying for the subsidy, the new fund will have a wider mandate to invest in developing the palm oil industry supply chain. The new subsidy was imposed just 6 months after President Jokowi received international acclaim for making good on his election pledge to scrap Indonesia's inefficient gasoline subsidy. So in the end one fuel subsidy was quietly swapped for another. The government argues that these policies are designed to boost energy security, reduce the current account deficit, and channel funds to a strategic national industry that alleviates poverty and supports millions of jobs. But central to the decision is the political desire to prop up palm oil prices, on which the fortunes of so many of Indonesia's politically networked conglomerates are based.

The attempt to substitute organic foreign demand by manufactured domestic demand is not a new one. It is also rarely successful for any length of time – as China's commodity sector and the global markets linked to it are currently discovering. Indonesia does not have the same deep pockets as China, and the financial sustainability of the palm oil subsidy scheme has already been questioned, with some officials dropping hints that the final programme of support may end up being a mixture of direct subsidies and tax breaks. The approach may also be subject to wider international challenge, including in the WTO, and is set to become a persistent irritant in EU and US commercial diplomacy with Indonesia.

Moreover, economic reality is struggling to keep pace with political ambition. Even in its current form, the scheme is falling far short of its targets. Indonesia only fulfilled 40% of its mandated blending target in 2014. Despite recent investments by a number of palm oil industry players, Indonesia does not have adequate refining capacity to deliver the mandated quantities of biofuel. In addition, even with the higher subsidy in place, blenders see little incentive to use palm-based biofuel when oil prices are so low.

For the global palm oil industry this is a complicated and problematic mix of short and long-term challenges. The conclusion here has to be a measure of scepticism about the cyclicality of the current price of palm oil. The World Bank forecasts that palm oil prices will remain stagnant up to 2020, then increasing by a modest 15% up to 2025, purely on the basis of global population and income growth; sustainability problems and buyer substitution suggest that even this modest outlook may be optimistic.

No less importantly, attempts to resist the sustainability and substitutability of palm oil are going to play out in politics and policy, driving further distortions to the market and the price. Indonesia's tactics in trying to head off a wider slump in demand through subsidy will be watched closely both in Brussels and Washington, but also in West Africa and other markets invested in palm oil prospects. Whether Jakarta can balance domestic vested and political interests and economic and fiscal reality remains to be seen. But for watchers of the palm oil market it suggests an uneasy ride.

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