Macro | FX Research and Strategy

Global

October 29, 2019

FX Flash

MYR - Assessing Potential Palm Oil Risks

Analysts

Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com.sg

Tan Yanxi
(65) 6320 1378
tanyx@maybank.com.sg

Christopher Wong
(65) 6320 1347
wongkl@maybank.com.sg

Fiona Lim
(65) 6320 1374
fionalim@maybank.com.sg

Palm Oil Exports Under Threat?

Malaysian palm oil prices have been rising steadily in Oct, with the crude palm oil (CPO) active contract for Jan 2020 showing a MTD rise of just below 10%. The rally was buoyed in part by signs of a recovery in palm oil exports in Oct, compared to previous months. A spike in palm oil prices on China's Dalian Commodities exchange, a soft MYR, and requirements for Malaysian and Indonesian fuel to have 20% and 30% biofuel-content in the form of palm oil (anchoring future demand), respectively, also likely contributed to the step-up in prices.

Malaysian palm oil accounts for more than a quarter of total global production. Vegetable oil is estimated to contribute to slightly below 3% of Malaysia's GDP and more than 4% of total exports last year. While a weaker ringgit has been known to boost demand for the commodity at times, it is also likely that significant shifts in CPO demand could have spillover impact on ringgit demand and sentiments as well.

In this note, we seek to assess a potential threat to palm oil demand, and hence MYR, given **recent concerns over calls made by a key Indian vegetable oil trade body, the Solvent Extractors' Association of India, to avoid purchases of Malaysian palm oil**. There are also rumours of a potential tariff hike on Malaysian CPO imports in New Delhi.

Notably, developments on this front are still playing out, and the official stance of the Modi Administration on the issue is also as yet uncertain. Moreover, the main alternative CPO supply, i.e., Indonesian CPO, faces its own supply constraints, and will be unlikely to meet significant diversions in Indian demand. Palm oil accounts for nearly two-thirds of India's total edible oil imports. In the interim, our view that MYR should remain supported into 2020 remains intact—there are other factors including resilient domestic growth, supportive Budget, cautious optimism in US-China trade relations etc., supporting the MYR.

In this assessment exercise, we utilize impulse responses from a Vector Autoregression (VAR) estimation to show that at peak impact, a 1% fall in Malaysian trade balance could potentially lead to a 0.4% rise in USDMYR (i.e., softening of MYR against USD).

Hence, in a **"mild" adverse scenario** where Indian purchases of Malaysian palm oil is reduced by 10% per quarter, and trade balance concomitantly falls by ~US$60mn (~0.8%), **MYR could potentially soften by 0.3% against the dollar**, *ceteris paribus*. In an **"extreme" adverse scenario** where Indian purchases are reduced by half per quarter, trade balance could fall by ~US$300mn (~4%), with a resulting **impact of around 1.6% decline in MYR against the USD**, *ceteris paribus*.

Risk Remains, With Some Potential Reprieve

Developments are still in flux, and Malaysian officials could be arranging meetings with the Solvent Extractors' Association of India or the Indian government to mitigate tensions. We also note that the official stance of the Modi Administration on the issue is also as yet uncertain.

Here's the short time-line of events (with negative/positive impact on sentiments highlighted):

27 Sep 2019, Dr Mahathir: "*Now, despite UN resolution on Jammu and Kashmir, the country has been invaded and occupied. There may be reasons for this action but it is still wrong. The problem must be solved by peaceful means. India should work with Pakistan to resolve this problem.*"

21 Oct 2019, Solvent Extractors' Association of India: "*It would be in fitness of things, as responsible Indian vegetable oil industry, we avoid purchasing of palm oil from Malaysia till such time clarity on the way forward emerges from Indian government.*"

23 Oct 2019, Tamil Nadu Congress Party: "*Any reduction of palm oil imports from Malaysia by India will hit hard the migrant workers from the southern Indian state of Tamil Nadu currently employed in Malaysia…Thus, the Tamil Nadu Congress party is urging the Modi government not to reduce the import of palm oil from Malaysia.*"

Reliance of Malaysia on India for Palm Oil Purchases has been Rising

Shares in Malaysia's Palm Oil Exports (%)

Country	2015	1Q to 3Q 2019
China	14	12
EU	14	11
India	21	28
Others	51	49
Total	*100*	*100*

Source: Malaysian Palm Oil Board, Maybank FX Research & Strategy

Alongside the push among EU countries to slowly phase out palm oil biodiesel due to its perceived links with deforestation, and China's slowing growth momentum, India's share in Malaysia's palm oil exports has grown over the past few years, from 21% in 2015 to 28% in 1Q to 3Q 2019.

Malaysian palm oil exports to India totalled around 3.9mn tonnes for the first three quarters of the year, valued at just below US$2bn (for comparison, Malaysian trade surplus is likely more than US$20bn for the same period).

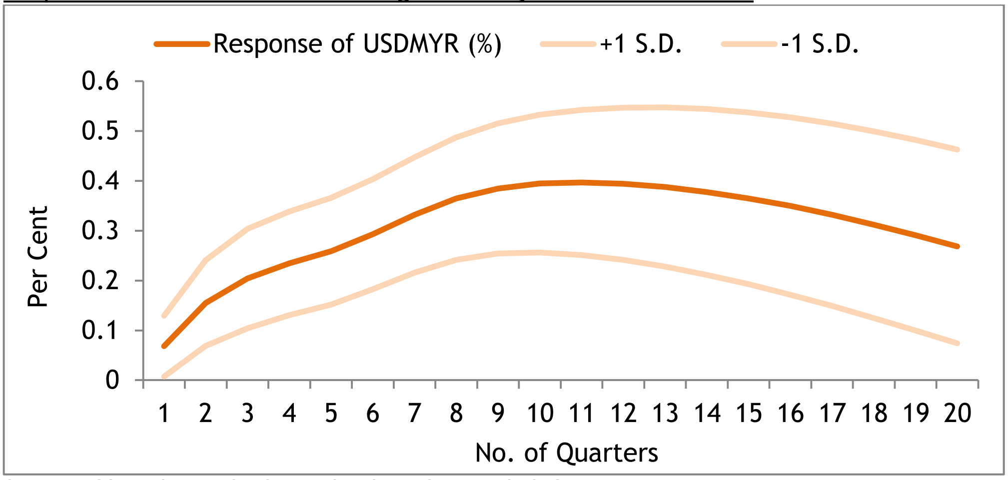
This rising dependence on Indian demand suggests that if tension on this front does escalate, and if an aggressive boycott develops, the potential impact on Malaysian trade surplus and hence MYR, could be relatively significant.

VAR Approach: Impact on USDMYR Could be Up to ~1.6% in "Extreme" Adverse Scenario

Accounting for the endogeneity between trade and FX (i.e., changes in FX affects demand for a country's goods, which in turn affects demand for the currency), we utilize a Vector Autoregression (VAR) approach to estimate the impact of a potential decline in Indian demand for Malaysian palm oil (via the reduction in trade balance) on the USDMYR.

The VAR is estimated in unrestricted form, and incorporates USDMYR, Malaysian Trade Balance and GDPs (income proxy) of key trading partners as variables.

Response of USDMYR to -1% Change in Malaysian Trade Balance

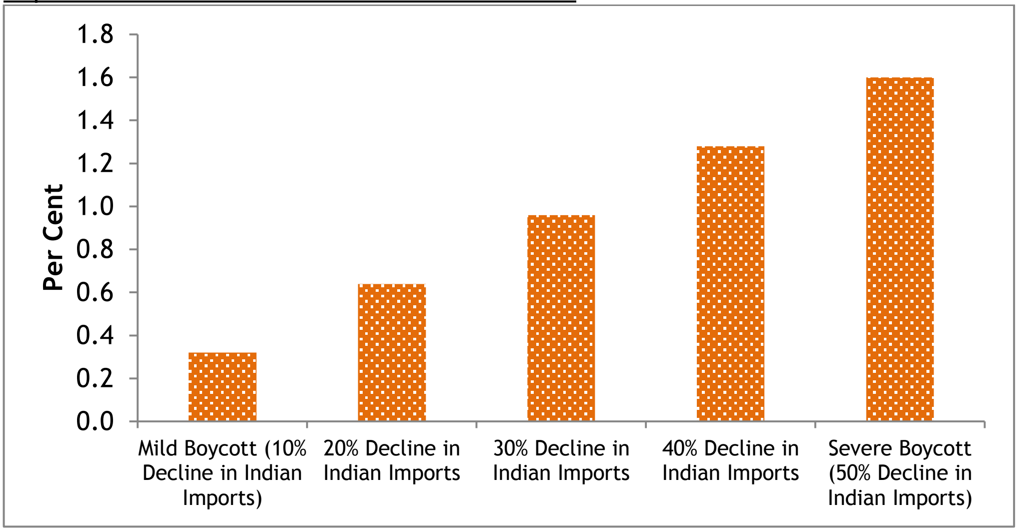


Source: *Bloomberg, CEIC, Maybank FX Research & Strategy*

Impulse response estimations from the VAR suggests that a 1% fall in Malaysian trade balance could potentially lead to a peak response of 0.4% rise in USDMYR (i.e., softening of MYR against USD), after around 10 quarters.

We utilize this elasticity and come up with a range of risk outcomes where actual partial boycott of Malaysian palm oil by Indian importers comes into play.

Impact on USDMYR Under Various Risk Scenarios



Source: *Bloomberg, CEIC, Maybank FX Research & Strategy*

In a "mild" adverse scenario where Indian purchases of Malaysian palm oil is reduced by 10% per quarter, Malaysian trade balance could fall by ~US$60mn (~0.8%), and the MYR could potentially soften by 0.3% against the dollar over time, *ceteris paribus*.

In an "extreme" adverse scenario where Indian purchases are reduced by 50% per quarter, the trade balance could fall by ~US$300mn (~4%), with a resulting impact of around 1.6% decline in MYR against the USD, *ceteris paribus*.

Nonetheless, we note that such developments largely remain a risk factor for now. The official stance of the Modi Administration on the issue is as yet uncertain. Moreover, the main alternative supply, i.e., Indonesian CPO, faces its own supply constraints, and will be unlikely to meet significant diversions in Indian demand. Palm oil accounts for nearly two-thirds of India's total edible oil imports.

Other factors including resilient domestic growth, supportive Budget, cautious optimism in US-China trade relations etc. should also support the MYR in the interim.

USDMYR Daily Chart - Indecision; Break-out Soon?

Source: Bloomberg, Maybank FX Research & Strategy

USDMYR consolidated in narrow range last week and showed a tad of downward pressure today. Pair was last seen at 4.1825 levels. Daily momentum and stochastics indicators are not showing a clear bias for now. A symmetrical triangle pattern appears to be in the making—an indication of indecision, and the pair could possibly see a breakout (direction unknown) in coming sessions. Immediate support at 4.18, 4.1680 (100 DMA). Resistance at 4.1950, 4.20. Break-outs could take USDMYR either to 4.16 or 4.22.

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(Incorporated in Malaysia)

Saktiandi Supaat	Christopher Wong	Fiona Lim	Yanxi Tan
Head, FX Research	Senior FX Strategist	Senior FX Strategist	FX Strategist
saktiandi@maybank.com.sg	wongkl@maybank.com.sg	Fionalim@maybank.com.sg	tanyx@maybank.com.sg
(+65) 63201379	(+65) 63201347	(+65) 63201374	(+65) 63201378