India’s Gold Policy

Following a steep rise in the current account deficit (CAD) and declining forex reserves, the government of India raised the gold import tax last year to 10 per cent from 4 per cent and introduced in July the same year the 80:20 rule which requires that 20 per cent of all gold imports have to be re-exported. As a result, the official gold imports plunged reducing the trade deficit and, therefore, the CAD significantly. However, India’s appetite for gold continues unabated and with some relaxation of the rules gold imports have picked up again raising fresh concerns. In addition, smuggling of gold has been rising alarmingly. According to the World Gold Council 150-200 tonnes of gold entered the country through unofficial channels in 2013. It can be debated how the gold smuggling is being financed, but given its adverse impact on society, economy, and country’s security that is not really relevant. Thus the curbs on gold imports and the high import tax cannot be kept in place for too long as they will lead to re-emergence of organized gold smuggling and associated mafia.

The recent unexpected pick up in gold imports has led to fresh concerns and the current policy concerning gold imports seems to be under review of the government. This approach of periodically adjusting the import policy and imposing sundry restrictions in response to the ebb and flow of gold imports does not address the real problem which is India’s huge appetite for gold. Since gold imports neither contribute to production capacity nor enhance productivity, we need to take a closer look at the problem and put in place policies that can ensure that India’s demand for gold does not endanger its macroeconomic stability.

G***old demand***

Demand for gold has two main components: jewellery and investment purchases. Of the two, jewellery demand is by far the largest. Despite higher domestic prices of gold, jewellery demand was up by 11 percent at 612.7 tonnes in 2013 compared to 552 tonnes in 2012. This trend, unless checked, is likely to continue and become even stronger in the near future. That is because approximately 28 percent of India’s total population of more than 1.2 billion is in the 15-30 year age group. That is a very large number of young people who are likely to get married over the next fifteen years. Since marriages in India seldom take place without some gold jewellery for the bride, the demand for gold, unless controlled, will increase many fold over the next fifteen years. Since both exports and foreign capital inflows are subject to external factors beyond the control of the government, India may face macroeconomic instability in the near future if its demand for gold is not tamed.

At the height of a worsening CAD, the then finance minister P. Chidambaram appealed to Indians to buy less gold. They responded by buying even more gold. From time immemorial, Indians have been enamoured of gold. This has only become stronger overtime because of aggressive marketing by producers of gold jewellery. Many newspapers and glossy magazines are full of advertisements which promote and create desire to own gold jewellery. Celebrities and favourite movie stars often appear in these advertisements. For instance, a promotional advertisement for the products of a branded jewellery house appeared this year on the first two full pages of a national daily on four consecutive days with pictures of no less than the most popular film stars. Movies and TV serials depict mother-in-law harshly treating her daughter-in-law if she does not bring enough gold jewellery. Is it then any wonder that Indians continue to be fascinated with gold and cannot be weaned away from it by mere appeals? In fact, it is contradictory to appeal to buy less gold on the one hand and allow huge advertisements promoting gold jewellery on the other hand. If the government is really serious about taming Indian demand for gold as it should be, then all advertisements promoting gold jewellery ought to be banned. Having such a ban will not be the first of its kind as bans have been successfully imposed previously on advertisements for cigarettes, alcohol, and a few other harmful products. Since buying gold is harmful for India's economic health, a similar ban on advertisement promoting gold is in national interest. Going even further, every jewellery shop or showroom may be required to display a signboard with the inscription "Buying Gold is Injurious to Your Country's Economic Health".

Indians are among the few who prefer 22 or higher carat gold jewellery. Anything of lesser cartage is taboo. However, the advertisement referred to above also claimed that "Markings like 916, 916SLD, 916 KDM, 22/20 etc., are not guarantees of purity. They are markings made by retailers themselves and most often, it would have only 18/19/20 carat purity. This has been confirmed further by MMTC-PAMP -- India's first internationally accredited refinery -- that 18 to 22 carat jewellery often contains 15-20 % less gold than claimed by the seller. Thus, banning sale and purchase of gold jewellery of more than18 carats will benefit consumers, make gold jewellery of 18 and lesser carats socially acceptable and less taboo, and most importantly reduce India's demand for gold by several percentage points. Production of Gold jewellery of 22 or more carats may be permitted, if at all, for export only.

These two measures will certainly dent demand for gold jewellery among urban consumers, but may not be as effective in rural areas. Gold is extremely important in rural India as banking penetration is low. Investing in gold jewellery is seen as an easy route to liquidity. In case of a financial crisis or unexpected need, it can be mortgaged with the local moneylender to get ready cash. Thus, greater banking penetration, spread of micro financing, easy availability of consumption loans against other assets such as cattle, land, house, and machinery can reduce rural demand for gold. Pradhan Mantri Jan Dhan Yojna (PMJDY) is a step in the right direction and its scope may be expanded over time.

However, these policies may put at risk the livelihoods of some 3.5 million artisans employed in the gold jewellery industry. While that should be a concern, both government and the jewellers have to accept the fact that if India is to reduce its demand for gold then the industry has to innovate and change. Switching to semi-precious stones (those available domestically) and fashion jewellery – beside gold jewellery of lower caratage – can keep the industry growing. In fact, there is already a trend towards such jewellery, especially among the fashion conscious young Indians who are likely to get married in the next few years. This trend needs to be supported by both government and the jewellery industry.

The policies discussed above will diminish Indian's love for gold jewellery for good as in many developed countries, but their full impact may take time. Thus, some additional policies for quicker results may also be considered in the meantime.

Gold reserves

Over the years, Indian households have accumulated 20, 000 – 25,000 tonnes of gold, with a staggering market value of over one trillion US dollars. Since India's own output of gold has been negligible, much of this gold must have been imported at some point or the other by spending forex. India would never have had imbalance on its external account if much of this gold were not imported. However, all is not lost. Gold, after all, is convertible – in international markets -- to US dollars and other foreign currencies. If only some of the privately held gold can be turned into reserves that can be released to reduce gold imports in times of stress! How do we do that is a trillion dollar question?

Previous attempts to tap the privately held gold by floating gold deposit schemes have floundered, mainly because of low returns offered by them. Something different that does not have the same flaws is needed. For many years now the RBI has successfully used non-resident external (NRE) deposits and foreign currency non-resident (FCNR) deposits for borrowing forex in times of need. Returns on these deposits are flexible, in step with severity of imbalances in India's external account. At the height of worsening macroeconomic conditions last year the interest rate on five year US dollar denominated FCNR deposits rose to as high as 5.77 per cent per annum and to nearly 9 per cent per annum on NRE deposits. But only non-resident Indians can hold FCNR and NRE deposits and both principal and interest are repatriable.

An analogous scheme for resident Indians to hold deposits in exchange for gold can contribute to India's gold reserves without diminishing its foreign currency reserves. Under this scheme a resident Indian can hold a rupee deposit by depositing gold of equivalent value with a designated bank. On maturity, the deposit may be renewed or redeemed in rupees at the discretion of the depositor. Thus, unlike FCNR and NRE deposits, no foreign currency or interest earned goes out of the country and the gold deposited becomes part of the RBI reserves. The deposits should be tax free and interest rates may vary in step with those on FCNR and NRE deposits. Rupee and gold loans may be allowed against the deposits.

From the point of view of RBI, such deposits are better than FCNR and NRE deposits as they are not repatriable and gold being convertible in international markets is as good as having dollars, if not better. They should also be attractive to resident Indians who invest in gold as a hedge against inflation and rupee depreciation.

Some estimates have put the availability of scrap gold at 300 tons per year. Thus, it may be possible to collect 150 - 200 tons of gold each year and build total gold reserves of about 1500 tons over a five year period; that is an addition of 950 tons to the current 550 tons of gold reserves without touching the foreign currency reserves.

A few safeguards may be necessary to prevent any misuse of the proposed deposits. First, the interest rate on these deposits should never be higher than interest rate net of taxes on rupee deposits. Second, PAN or UID may be made mandatory for all gold related transactions so that a paper trail is created to track new sales/purchases and ownership of gold. These safeguards if strictly enforced can prevent use of black money and any spike in demand for gold due to the introduction of the proposed deposits.

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