Y V Reddy: Evolving role of gold – recent trends and future direction

Address by Dr Y V Reddy, Deputy Governor of the Reserve Bank of India, at a conference organised by World Gold Council, New Delhi, 21 March 2002.

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Mr. Chairman, Mr. Tarapore, Distinguished visitors and friends,

I am thankful to the World Gold Council (WGC) for inviting me to participate in this meeting on the future direction of the gold market. This is the third conference of WGC, with which I am being associated and I do notice that all of these are held in New Delhi. It shows that though Mumbai is the financial capital and a major centre for gold market in India, the directions of gold policy have been and will continue to be rightly decided by Government of India (GOI) from New Delhi in close consultation with Reserve Bank of India (RBI). Though my association with such conferences can be traced to the WGC conference in 1996, my association with gold policy in India and management of gold reserves with RBI goes back to 1991. In some capacity or other, I happened to participate in almost all the legislative, policy and procedural changes relating to gold policy from the Ministry of Finance and from the RBI for over a decade. In the recent years, I have had the benefit of excellent advice from the Standing Committee on Gold and Precious Metals in RBI which has participation from Ministries of Finance and Commerce of GOI.

I find in this gathering, outstanding experience on world gold markets, and hence my initial narration of recent global developments would be brief with focus on the official sector. However, I will recall in detail, recent developments in regard to gold markets and gold policy in India in the second part. The third part will capture some aspects viz., consideration of risk and return on investments in gold in India; results of recent research on gold markets and consideration of some proposals relating to gold. The fourth part will review India’s experience with gold policy and help set some parameters for medium-term gold policy. The concluding part will briefly explore future directions of gold policy and markets in India.

Recent global developments: focus on official sector

According to the available data in public domain, the events during the last decade in the international bullion market were dominated by the official sector mainly by central banks, especially through sales and leasing, with consequential impact on gold prices. On the supply side, mine production during the first 5 years was almost flat, while in the latter half of the decade, it gradually went up. Official sector sales recorded substantial increases and amounted to about 450 to 500 tonnes in the year 2000. Addition to supply from hedging ranged from a low of 100 to a high of 500 tonnes each year. Mining, official sector sales and leasing together have provided reasonable liquidity to the market. As regards demand, data indicates that up to 1995, annual demand on account of jewellery fabrication was of the order of 2,600 tonnes which zoomed by about 30 per cent in 1997, and in the last 3 years, it averaged 3,150 tonnes. The most important factor on both the supply and demand sides was that mine production and demand for jewellery fabrication remained flat during 1988-2000 on an average at 2,550 and 3,250 tonnes, respectively. Yet, there has been abundant liquidity.

Flat demand and declining prices in addition to institutional developments, may have had much to do with the changed attitude of central bankers, particularly in Europe. The official sector sales, which amounted to 130 tonnes in 1994, progressively went up and recorded 470 tonnes in 2,000. More importantly, the official sector leasing, which was just below 1,000 tonnes in 1991 went up to about 4,800 tonnes, adding to liquidity in more than ample measure with some impact on the prices. Low inflation and soft interest rates in the recent years have brought about a greater sensitivity among central banks regarding returns on their portfolios.

The steady decline in gold prices in recent years against the background of low inflation raised doubts in some quarters, on the importance of gold as a safe haven investment and hedge against inflation. Some central banks have resorted to off loading substantial quantities of gold, which they held as reserves. Another significant development of the 1990s was the spurt in central bank lending of the precious metal. Central banks are lending their idle stocks with a view to enhancing returns on reserves, which is bringing in good liquidity to the market to bridge the gap between supply and demand. A notable development in this regard is the signing of the Washington Agreement by some central banks in September 1999, which has placed an effective cap on such operations of central banks.

As a result of the clear trend that emerged in recent years of increased amount of central banks' sales as well as lending, the official sector's holdings as a percentage of total above-ground stocks fell from about 30 per cent in 1996 to 23 per cent in 2000. The central banks across the world were holding about 33,000 tonnes as at the end of 2000 as compared to about 36,000 tonnes at the beginning of 1991, which reflects substantial sale by many European central banks. The Reserve Bank of India (RBI) holds 357.75 tonnes of gold forming about 6 per cent of the current value of its total forex exchange reserves. Our reserves management as regards gold can be termed as passive and conservative as RBI does not sell gold or trade in gold.

Recent developments in India

WGC has estimated that the annual Indian demand for the precious metal in recent years has been in excess of 800 tonnes. Most of it appears to be meant for jewellery fabrication, and the rest, estimated at 10 to 15 percent, is possibly meant to meet demand on account of investment and industrial processes. A major step in the development of gold markets in India was the authorization in July 1997 by the RBI to commercial banks to import gold for sale or loan to jewellers and exporters. Initially, 7 banks were selected for this purpose on the basis of certain specified criteria like minimum capital adequacy, profitability, risk management expertise, previous experience in this area, etc. The number of banks later went upto 18. On a review, since five banks had not evinced adequate interest in this business in terms of activity, the RBI did not find it appropriate to renew their licences for this purpose. At present, 13 banks are active in the import of gold. The quantum of gold imported through these banks has been in the range of 500 tonnes per year.

Import of gold by banks authorised by the RBI has succeeded to a large extent in curbing illegal operations in gold and in foreign exchange markets. It has also resulted in reducing the disparity between international and domestic prices of gold from 57 per cent during 1986 to 1991 to 8.5 per cent in 2001.

The import duty on gold, which was Rs.220 per ten grams upto January 1999, was increased to Rs.400 per ten grams, and with effect from April 2001 has been reduced to Rs.250 per ten grams. The estimates of duty realised from gold imports indicate an annual amount varying from about Rs. 1,000 to Rs. 2,000 crore per annum since 1997.

Even though the country consumes more than 800 tonnes of the metal every year, the system of assaying and hallmarking has not gained the desired importance. The low quality of gold jewellery being sold in the country and the resultant losses being incurred by the consumers are being recognized now. Recent surveys conducted by the Bureau of Indian Standards (BIS) jointly with Central Consumer Protection Council in 5 major cities reveal that more than 80 per cent of the jewellery being sold in the market was of lower purity than claimed and charged for. In some cases, the gold articles sold were 38.6 per cent short in purity in monetary terms. The low purity results in a loss of around 16 per cent to gold jewellery.

In the recent past, RBI has been actively pursuing the issue of upgrading the quality of trade and products through a system of assaying and hallmarking with Government of India and BIS. The major objectives of introducing a proper assaying and hallmarking system in the country are enabling consumer protection, developing export competitiveness of the gold jewellery industry, introducing gold based financial products, which will help in mopping up the vast dormant gold resources with the domestic sector and developing India into a leading gold market centre in the world.

Ministry of Commerce had held meetings with the trade representatives in 1997. Based on the views emerging out of these consultations, BIS formulated a scheme of hall marking in 1998, as a Voluntary Certification Scheme, with a combination of quality certification and BIS Laboratory recognition schemes. The BIS-recognised laboratories would affix/stamp/hall mark jewellery manufactured by BIS certified jewellers and BIS in turn would maintain the required surveillance.

As a culmination of further efforts by all concerned, BIS launched the scheme of hallmarking in April 2000 under the BIS Act, 1986. Under the Scheme, 12 firms of jewellers have been certified as assaying and hallmarking centres so far. Consumer awareness campaign highlighting the advantages of going in for hallmarking jewellery is being conducted by BIS.

The Government of India announced the Gold Deposit Scheme in 1999 and RBI issued guidelines to the banks intending to launch the scheme in October 1999. Five banks have launched their schemes under the guidelines and the quantum of gold mobilised so far has been about 7 tonnes. Unfortunately, the scheme has not evoked the expected response. A number of reasons can be cited for the low response, prominent among them being depositors' losing the making charges spent on jewellery (as the banks would convert them into primary form before accepting as deposits), the low caratage of jewellery, low rate of return on deposit (as seen by the depositors) and the absence of any amnesty.

Some aspects of gold market in India

Risk and Return on Gold Investments

The return from investments in gold may be compared with the return on investment in Government bonds in the Indian markets. Illustratively, if gold had been purchased at end-February 1996 and sold at end-February 2002 at the prevailing rates in the local bullion market, the average annualised return would work out to be negative. On the contrary, investment in a liquid risk-free Government security on the same date would have fetched a comfortable positive return, and in case capital gains through marked to market is also taken into account, the annualised average return could be as high as 15 per cent.

Recent Research in Gold Markets

A DRG study (Gold Mobilisation Instrument as an External Adjustment) prepared in the RBI in 1992, tested five factors for their influence on demand for gold: they are, generation of large market surplus in rural areas as a result of all round increase in agricultural production, unaccounted income/wealth generated mainly in the service sector, comparative rate of return available on alternative financial assets like bank deposits, units of UTI, small saving schemes etc., price variation in gold and price of other commodities. The study led to the conclusion that the first two factors i.e. rural surplus and unaccounted income in the service sector have far more influence on gold demand than the other factors.

In another analysis made by Shri Vaidyanathan in 1999, (Economic and Political Weekly, February 20, 1999) the factors determining the demand for gold were studied. The parameters taken into account were GDP, ratio of household financial savings to national product, domestic price of gold, GDP deflator, index of ordinary share prices and the difference between domestic and foreign price of gold as percentage of international prices. The study established that gold imports tend to be higher when domestic gold prices rise relative to those of ordinary shares and international gold prices; but, the effect of these two variables was pronounced during 1991-96 as compared to 1970-90.

Dr. Saumitra Chaudhuri (Financial Express, November 26, 2001) made an analysis of the possible choices for a saver between interest bearing financial instruments and gold. He advocates that in Indian conditions, a return of less than 6 per cent for a saving instrument would induce the saver to invest in gold.

Mr. N.A. Mazumdar, in many of his articles, has been holding the view that a capital starved country like India cannot afford to utilize foreign exchange on a commodity like gold. He holds the opinion that the consequences of the gold liberalization policy could be alarming, especially in view of the fact that such imports of gold are unrelated to India's exports of jewellery.

Some Proposals Relating to Gold

A proposal was made for setting up a Gold Index Fund by mobilising gold through collection centres in major cities, swapping the gold for US dollars and investing the US dollar funds in corporate debt and high yielding off-shore investments. The average return envisaged was 20 per cent for the depositors. RBI's view was that the off-shore high yielding investments as contemplated would be too risky for the institution mobilising gold and there is a risk that it may not be able to service the gold deposited by the customers without a loss to itself. It was also felt that a financial institution without adequate branch network may not succeed in mobilisation of adequate quantities of gold.

Proposal from certain banks for launching Gold Accumulation Plan Certificate was considered by the Standing Committee on Gold and Precious Metals. However, it has not been pursued further in view of the poor response to Gold Deposit Scheme.

Another proposal related to issue of gold bonds with a 5-year tenure and liquidity provided by an international investment company. This scheme was designed to enable higher yield pick-up on the country's gold reserves. The proposal was not pursued since it may not be appropriate to lock up gold for a long tenor of 5 years, and such bonds were being issued for the first time by the institution.

Yet another proposal for substituting the gold imports by borrowing gold on lease on long-term basis was also posed and it was decided that the proposal is not practical as huge quantities of gold will not be available for lease on a long term basis, apart from the fact that such lease will only amount to borrowing in gold with attendant foreign currency risk as well as gold price risk.

Proposals for location swap of the gold stock in RBI's reserves with bullion banks and institutional swap (swapping our gold with gold imported by authorized banks) have also been made as means of enhancing the quality of gold to internationally acceptable standards, but these are not pursued in view of passive approach to the policy.

Gold Policy: Review of Experience

Our experience with various policy measures may be reviewed in terms of gold control, prohibition of gold imports, gold sales, gold mobilisation and liberalised gold policy.

The evolution of the gold control policy since independence was centered around some major objectives, viz., weaning away people from gold, regulating the supply of gold, reducing the domestic demand and prices and curbing smuggling. In the wake of the Chinese war, it was felt in some circles that it would be feasible to make a frontal attack on demand for gold in India. Accordingly, the Gold Control Order 1962 was issued, banning the making and selling of jewellery above 14 carats, making it compulsory for gold smiths to be licensed and submit accounts of all gold received and utilised by them etc., The measures met with lot of resistance and criticism. This coupled with administrative complexities resulted in the failure of the Gold Control order.

Bullion imports and exports were also banned but restrictions on import of gold into the country resulted in the flourishing of smuggling and unofficial transactions in foreign exchange. Official imports to discourage smuggling was first mooted in 1977 but viewed against the forex reserves available then, it was thought as an impossible proposition. The Government decided to sell confiscated gold in small quantities through the RBI. However, it did not have any major impact on smuggling.

Various schemes for mobilisation of idle gold holdings have been implemented by the Government and RBI in the past, but with little success. The 15-year Gold Bonds at 6 1/2 per cent (November 1962) could mobilise only 16.70 tonnes. A second attempt to garner gold was made through the 7 per cent Gold Bond 1980 Scheme (March 1965) which could mobilise only 6.1 tonnes. The third series designated as National Defence Gold Bonds 1980 (1965) garnered 13.7 tonnes and the Gold Bond Scheme 1993 garnered 41 tonnes of gold. Even after two years of launching the scheme under the recent Gold Deposit Scheme (1997) the mobilization is around seven tonnes only. Thus, attempts to mobilise gold under various schemes have not evoked the desired response.

Currently, gold import is permitted through three official channels viz., special import licences, non-resident Indians and authorized banks and institutions. Import of gold through Special Import Licence (SIL) has been negligible after gold import through banks was permitted. It is but natural that NRI route had become less attractive after the banks have been permitted to import gold.

The liberalized gold policy has certainly brought to the official sector what originally was an unofficial sector. Without doubt, it has eliminated illegal transactions and profiteers out of such illegal transactions with attendant socio-economic impact of such large scale and high value market involving cross-border operations. At the level of managing external sector and forex markets, the elimination of large unofficial market in forex has improved the policy effectiveness. It may also be noted that the Indian consumer of gold has been spared of huge transaction costs amounting to thousands of crores of rupees on account of the existence of the unofficial sector in the past. Further, duty realization is significant at a time when realization through customs duty on other commodities is coming down.

However, there are some who argue that ban on gold imports should be re-imposed, while a few others argue that the duty be hiked on the assumption that such measures would curb the total import bill on account of gold. Past experience does not seem to favour this negative view. In this regard, there is another view which holds that both gold import and export should be totally freed, but this argument ignores the fact that gold has some characteristics of a currency.

Parameters for Medium-term Policy

In the light of the experience gained in the global trends in the gold market, and more particularly the recent trends in gold policy and gold markets in India, it is possible to suggest five broad parameters that could govern the medium-term policy in regard to gold.

A positive approach to gold appears to be demonstrably less disruptive and more consistent with socio-economic conditions in the country than a negative approach to gold, as amply demonstrated by the ineffectiveness as well as disruptive nature of the control framework in the past. The response to measures aimed at discouraging utilisation and possession through schemes such as gold mobilisation and gold deposits have also not worked.

A positive approach significantly reduces transaction cost as evident, for example, from the reduction in difference in price between world markets and Indian gold markets after liberalisation. As mentioned earlier, a liberalized policy has added the comfort to public finance and management of external sector. Further, a non-positive attitude towards the use of gold on the presumption of the expenditure being productive or non-productive would be inconsistent with the liberalised framework of economic management. Thus, it would be inconsistent to allow consumption of luxury items or perfumes through imports, but not gold. Moreover, unlike tobacco and to some extent liquor, gold does not have adverse impact on health, environment or family life. In other words, it would not be proper to make any judgement about the desirability or productive nature of gold consumption to weave the policy around such a value loaded judgement. It would be appropriate to assess the Indian reality and the implications of large preference for holding gold and take appropriate policy measures. On the basis of such an assessment, a positive approach will have several dimensions viz. macro policy, financial markets, external sector and protection of consumer interest.

In terms of macro policy, the objective of reduced recourse to gold would be automatically served in the long run through economic development, though the immediate effect of increased prosperity could be preference for investment in gold. Spread of literacy, particularly female literacy, could also help in reducing the preference for gold. Above all, availability and easy access to different forms of financial savings on an extensive scale, particularly for women, to protect the traditional “Streedhan” may prove to be the most viable policy option to encourage non-gold form of savings. Of particular relevance to monetary authorities, price stability and reasonably low but stable interest rates are in the medium-term, likely to contribute to reduced preference or recourse to gold as a form of savings as well as investment.

As regards the role of gold in financial markets, the policy has to recognise that the Indian gold market has always been linked to international gold market in view of large requirements of imported gold. Recognition of such integration as an inevitable reality and taking appropriate institutional measures, would reduce the transaction cost and impart stability to the Indian gold market. Further, gold has been virtually insulated from the local financial market in terms of financing of the gold or gold transactions by the banking sector. Gold-linked financial instruments are not prevalent in the Indian market and forward markets in gold are virtually prohibited. Given the inevitable integration between the global and local gold markets, there is considerable merit in following the global practice of integration of gold markets with financial markets. The role of banks in the context of gold market has already been recognised, but banks are playing the role of essentially being canalising agencies. While such a risk free approach is defensible from a prudential angle, banks could fund financial instruments without taking a risk on their own balance sheet, thus improving efficiency in the gold-linked financial markets.

In respect of the external sector, the liberalisation of import of gold has helped the removal of non-official transactions to a significant degree. However, the export of gold jewellery is still somewhat insulated from the domestic market. The economic opportunities for considerable liberalisation of exports could be considered as appropriate. Special treatment of gold export will no longer be consistent with the positive approach to gold policy coupled with a vibrant role of gold in external trade.

Finally, studies have shown that the consumers on an average would be paying Rs. 8,000 crores extra each year by virtue of the questionable quality of gold sold to them. In particular, the rural and middle class and women are specially vulnerable to the low quality of gold. Special consumer protection measures - both educational and legal through appropriate enforcement of Consumer Protection Act - should make a positive contribution to the protection of consumer and improvement of the industry.

Future Directions

The broad parameters for medium-term policy would by themselves suggest several actions for the future. It may be appropriate to consider discussion and debate on the parameters of the policy indicated. However, on an illustrative basis, it is possible to identify broad areas for future direction in this regard.

First, there may be scope for further rationalisation of policy relating to import of gold. Experience has shown that select large institutions, particularly banks, contribute effectively to efficient import of gold. However, as a hangover of the past, a number of facilities are available for NRI individuals to import gold. There is considerable merit in reviewing the policy with a view to removing such individual-based special facilities. When gold is imported through NRIs, it may not be easy to track the origin or destination, hence making it vulnerable for misuse. Prohibiting such imports may also be consistent with other initiatives such as prevention of money laundering, since unlike in the banking system, the transactions are not easily traceable. Similarly, import of gold through special import licence may need review. At the same time, consistent with a positive approach to gold, the current restrictions on import of gold as part of personal baggage by returning Indians could be reviewed. Gold may not be treated differently from any other commodity in respect of eligibility as personal baggage within the allowance and levy of the standard duty on import in excess of permissible limit on par with other goods.

Second, as regards exports, consistent with the positive approach, it should be possible to remove special restrictions on gold jewellery export-oriented units and treat them like other units. Mechanisms such as customs bonding etc. may no longer be necessary, if the purchase of gold is documented and export proceeds realised are fully documented. The strategy adopted by Italy for a number of years and more recently by Turkey to dominate gold jewellery markets may have to be studied in depth for adoption in India

Third, in regard to development of gold market, the establishment of a Gold Exchange would help in efficient price discovery and emergence of healthy and transparent practices in the market. The basic framework for such an exchange already exists with 13 banks active in import of precious metals. Five of them have launched the Gold Deposit Scheme also. They are exploring possibilities of introducing ‘paper gold’ products like Gold Accumulation Plans. These banks are fully authorised to sell/lease gold to the market players. They can also enter into forward contracts in a limited way. A committee set up by the RBI has studied the feasibility of introducing Futures Trading in Gold and this is being examined by the Forward Markets Commission. Once the banks start trading among themselves, with MMTC, STC and also with big traders according to the demand/supply dynamics, a formal move towards a Gold Exchange is appropriate. They can even use the infrastructure available with an existing stock exchange like National Stock Exchange (NSE) for this purpose.

Fourth, as part of the positive approach to consumers, the present initiatives by BIS may be supported, strengthened for improvement, reviewed and further measures considered. For example, several banks and other institutions, which are currently importing gold in large measures, could consider establishing a Gold Market Development Agency as a voluntary self regulatory organisation with participation from gold trade and BIS to devise mechanisms by which the efficiency of the market and the integrity of the products are ensured and augmented. For example, banks can play a role by prescribing different margins for loans extended against the pledge of gold with hallmark and those without. Similarly, the banks could take into account, the practice of issuing Gold Content Guarantee Certificates by the gold jewellers while extending credit. This would also help banks in making proper assessment of the inventories of the traders.

Finally, with a full recognition of the importance of gold, not only in the Indian economy, in terms of import, export, or consumption, employment, etc., but also in the Indian society, it would be desirable to encourage research and policy studies on various aspects relating to a positive approach to gold markets and gold policy. Illustratively, these may cover three broad areas, viz., gold reserves and their role in the forex reserves; the development of gold markets in conjunction with financial markets; and the macro economic implications of gold policy and gold markets, especially in the context of financial savings.

Let me again thank the organizers for giving me this opportunity and we in RBI as usual look forward to benefiting from the deliberations.