India's Attempt at Gold Monetization – Breaking the Bond with Gold

Ramakrishna Kashelkar, *Research Scholar (Ph.D.), Modern Institute of Business Management University of Pune 05. E-mail : ramkrishna.kashelkar@gmail.com*

Introduction

India's recent proposal to launch gold monetization scheme may not be something unique or new – we already had Gold Deposit and Gold Metal Loan schemes apart from Gold Bonds launched in 1993, all of which suffered from a number of flaws. Nevertheless, the entire approach is innovative and investor friendly, which can add to its success this time. The scheme is yet not fully implemented, and hence a number of key details are not yet available. Provided the costs and benefits are favourable to investors and the government succeeds in their marketing and distribution, these schemes can finally break India's bond with the gold. There will be triple benefit from this – investors will be able to own gold, without really buying it physically, jewelers will be able to get the metal at low cost, while the government's borrowing costs may go down. On the one hand, the huge stockpile of gold held by the Indian households will get converted to financial assets, while on the other the current account deficit will get curbed by reducing imports.

Global Gold Demand Scenario :

Globally gold has emotional, cultural and financial value, besides industrial usage. Gold is converted into jewellery, used as a hedge against volatility or inflation in managing investment portfolios, besides being used as the ultimate reserve by the central banks across the world. Gold is one of the few assets that is universally accepted by the world's central banks and hence plays a prominent role in reserve asset management. The metal also finds its way in components of smart phones and medical diagnostics and dentistry, apart from industrial catalysts. Thus, gold demand comes from diverse sets of entities – consumers, investors, central banks and manufacturers.

According to World Gold Council, nearly 50% of global demand for gold between 2010 and 2014 was from jewellery. India and China represent nearly half of this demand due to cultural reasons and limited access to financial investments. Nearly one-third of the global demand for gold is for investment reasons. This is made up of owning gold bars or coins or through Exchanged Traded Funds (ETFs). The demand for gold from central banks has increased from mere 2% in 2010 to nearly 14% of the total in 2014. Industrial demand for gold was around 9% of total demand with electronics industry representing the biggest chunk.

Print ISSN NO. - 2347 - 2405

According to the statistics made available by the World Gold Council, the world's total consumer gold demand was estimated at 3467.3 tonne, out of which 1004.4 tonne or 29% was towards investments and 2462.9 tonne or 71% were for jewellery. For India the investment demand made up nearly 25% of the 811.1 tonne consumer demand in 2014.

Need for Gold Monetisation :

India is world's second largest consumer of gold behind China and represents over 23% of global consumer demand for gold, according to World Gold Council. Nearly 90% of the overall domestic demand is met through imports making gold the second largest item in India's import bill next to petroleum. In 2013 when the widening current account deficit had become a key worry and rupee depreciated to record low level, the government attempted to curb the gold imports through successive customs duty hikes and other regulations. Subsequently, the new government expanded the list of entities who could import gold in May 2014 and in Nov 2014 scrapped the 80:20 rule that mandated importers to re-export 20% of their shipments.

The government had earlier announced introducing Gold Monetisation scheme to curb this runaway demand for the yellow metal, which economists consider as unproductive investment. After an announcement in 2015-16 budget the cabinet headed by Prime Minister Narendra Modi on 9th Sept 2015 approved two schemes – Sovereign Gold Bonds Scheme (SGB) and Gold Monetisation Scheme (GMS) – for this purpose.

Sovereign Gold Bonds Scheme: This scheme aims to divert incremental investor demand for gold as a financial asset. Any person willing to buy gold coins or bars as an investment can instead invest in SGBs. SGBs will ensure the investor is able to buy the exact same amount of gold on maturity, which she was planning to buy on day of investment. In addition, the investor will get a tax-free interest. The bonds will be government backed offering maximum security and tradable on exchange to offer premature liquidity. While the government notification has mentioned the bonds' term to be 5-7 years, the rate of interest is not disclosed.

In the international market there are designated Bullion Banks, which borrow or lease gold from large holders like central banks and either lend or outright sell to the users. These Bullion Banks offer certain interest to the gold lenders, which is presently around 0.4% per annum for 12-month period or nearly half of 12-month LIBOR. It is believed that the interest rates for the SGBs will be linked to the repo rates in a similar manner.

While the investors' enthusiasm in this scheme will depend upon the interest rates on offer, the government has to bear the gold price risk. Hence, it will create a Gold Reserve Fund using the savings in its borrowing costs as compared with the prevalent rate on government borrowings, to be monitored closely.

Print ISSN NO. - 2347 - 2405

Other key features of the SBGs :

- Sovereign Gold Bonds will be issued on payment of rupees and denominated in grams of gold.
- The bond would be restricted for sale to resident Indian entities, with a cap of 500 grammes per person per year.
- The bonds will be available both in demat and paper form.
- The bonds will be issued in denominations of 5, 10, 50, 100 grams of gold or other denominations.
- Tax treatment for SGBs will be the same as for physical gold for an 'individual' investor.
- On maturity, the depositor will be given an option to roll over the bond for three or more years.

Gold Monetization Scheme (GMS)

This second scheme approved by the cabinet aims at inducing Indians to convert their existing idle stock of gold – either jewellery or bars and coins – into financial assets. Under this scheme, anyone owning gold can deposit it in **Gold Savings Account** with a bank. The account, which could be opened for a period from 1 year to 15 years, will earn the depositor interest in the form of additional gold. The banks will ask interested jewelers to open **Gold Metal Loan** accounts with them and lease such mobilized gold to them for a period upto 180 days. Alternatively, the banks will have the option to auction the gold or lend to RBI.

While the scheme can be very attractive to existing gold investors, the procedures can be somewhat cumbersome. Initially, the depositor will need to test purity of her gold at an Assaying and Hallmarking Centre approved by Bureau of Indian Standards (BIS), then deposit it with a refinery for melting and second purity check. Here the depositor will be issued a receipt for the amount of gold deposited, which needs to be submitted to the bank, where she plans to hold the Gold Savings Account. Likewise, in case of a redemption, the bank will issue a note while the actual gold will need to be picked up from the refinery.

Bringing together these three components – purity checking agency, refiner and bank – to offer a seamless experience to customers while keeping the costs low will be the biggest hurdle in implementation of this scheme.

This scheme, now being introduced pan-India, has been tried by individual banks in the past with limited success.

Indian households hold an estimated 20,000 tonne of gold, presently valued at $840 billion or nearly 40% of India's GDP. If a fraction of this gold finds way in to the market through this route, the need for incremental imports will drop drastically. The jewellery industry, which

Print ISSN NO. - 2347 - 2405

makes up nearly 12% of India's exports, will also get an assured low cost supply of its main raw material.

While the consumers may be reluctant to melt their jewellery pieces due to sentimental value, there is still a fairly large hoard of bars and coins in the country for investment purpose, which can find this avenue attractive. According to World Gold Council estimates over 25% of 811 tonne Indian demand for gold in 2014 was towards investment.

Conclusion :

The Government's aim to induce people to invest more in financial assets rather than gold is surely a step in right direction. Both the schemes to be launched for this purpose – Sovereign Gold Bonds Scheme (SGB) and Gold Monetization Scheme (GMS) – have the potential to change the way Indians look at gold. However, implementation holds key to their success. A whole-hearted cohesive effort from the financial sector with necessary regulatory interventions will prove essential.

❖❖❖

Print ISSN NO. - 2347 - 2405