DEREGULATION OF GOLD IN **INDIA**

Himadri Bhattacharya

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Deregulation of Gold in India

A Case Study in Deregulation of a Gold Market

Himadri Bhattacharya

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The views and opinions expressed in the article are author's own and do not in any way reflect the view or opinion of the Reserve Bank of India.

Introduction

India's far-reaching economic reforms over the past decade, including the liberalisation of the gold regime, are a welcome break with the past and may lay the ground for further reform.

This new work tracks the evolution of the reform process which had its origin in the balance of payment crisis of 1990-91. The paper discusses the historical roots of the unique position that gold has always enjoyed in the Indian society. The shifts in the policy regime regarding gold, particularly in the post-independence (post-1947) era, are dealt with extensively. The paper reveals in sharp relief how the dominant economic philosophy in general, and external sector policy framework in particular, significantly influenced specific policy actions on gold.

Deregulation of Gold in India provides an account of the gold mobilisation efforts on the part of the government from time to time. The various sections of the paper analyse different aspects of the policy regime. *Economic Reform and Gold* traces the genesis of and the imperative for the policy overhaul in the reform era. *Gold Market in India* provides a description of the market and makes suggestions for its further development. *Issues for the Future* covers a wide range of broad as well as specific issues that are likely to dominate the policy debate of gold in the years to come.

Deregulation of Gold in India offers policy-makers, gold-market participants and economic historians a comprehensive insight to into the historical and economic forces at work on gold in India. In revealing the contradictions implied by a closed regime on gold focused on demand suppression the paper seeks to contribute to the recent debate on gold with regard to: (i) an optimal import regime for gold, (ii) gold market development, and (iii) the monetary role for gold.

The paper's contemporary value lies in its being a case study on how reform measures can be sequenced as the opening up of the economy gathers momentum: a valuable insight for policy-makers elsewhere contemplating how to execute economic reform and liberalise gold markets.

Robert Pringle
Managing Director, Public Policy
August 2002

Deregulation of Gold in India

"*The story of gold has a deeper message, one that has none of the transitory qualities of what we choose to use as money. Seen in this broader sense, the story of gold has no ending*." – Peter Bernstein in **The Power of Gold**

In India, gold is as much a thing to be possessed as it is a concept. The word 'gold' in the ancient texts has wide meaning and connotations, ranging from the mundane to the sublime. In the Sanskrit language there are at least seven synonyms for gold, viz. *Swarna*, *Suvarna*, *Hiranya*, *Kanak*, *Kanchan*, *Hem* and *Ashtapada*. Gold in India serves many functions and wearing it has several implications. At the most obvious level, it is a form of adornment, and also a status symbol. For Hindus, gold is associated with most religious ceremonies, such as the naming ceremony or marriage. To signify marital status, Hindu women wear a special kind of necklace, which consist of gold pendants strung in a certain combination with beads made up of other materials. In certain parts of the country a goldsmith pierces a newborn child's ear with a gold pin in a ritual performed twelve days after it is born, often only in a symbolic manner though. The Indian epics, such as *Ramayana* and the *Mahabharata* are replete with descriptions of ornaments. Practitioners of traditional medicine in India claim that pure gold has several therapeutic qualities: when consumed regularly, gold is good for circulation of the blood and enhancement of the mind and lifting the spirit; gold applied to skin helps combat ageing. These claims, however, are not supported by modern medical science. Does gold have any taste? High quality gold is tasteless, as per the discerning connoisseur, who claims that gold tastes very good when eaten with chocolate.

Gold Economy

In India goldsmiths are usually men, and are referred to by a variety of names depending on the region. In the Vedic period (Second Millennium BC), goldsmiths had a much higher standing in society than most other artisans, probably because they worked with a precious metal. The goldsmiths enjoyed royal patronage. Historical evidence suggests that Indian jewellers had early mastery of the various skills required to make fine jewellery, such as mixing alloys, moulding, setting stones, inlay work, relief, drawing gold and silver into fine wires, plating and gilding. The duties of the goldsmith have been defined in an ancient social code, but are observed more by breach than by adherence. There is hardly any village or town, even in the remote corners of the country, where there is no goldsmith.

Today, the gold/jewellery industry is fast-growing, with impressive domestic and export sales. Gems and jewellery constitute one of the fastest growing export sectors in India, accounting for one-fifth of the aggregate exports. The current size of the gold economy is around US$ 6 billion and employs over half a million people. The number of gold jewellery manufacturing units is put at 100,000. Also, a large number of skilled goldsmiths/gold merchants from India are engaged in gold trade and industry in almost all the oil-rich Middle Eastern countries. However, for a long time in the existence of the gold economy, the producers and consumers of gold jewellery hardly found a place in any policy discussion on gold.

Gold Accumulation

How much gold is there in India? This is a quintessential question, but the answers are many. For reasons obvious in a country of continental dimension, it is not feasible to collect direct data by way of census to get a handle on the stock held, particularly by private households. The official estimate puts the figure at around 9,000 tonnes, although much higher estimates range between 10,000 and 15,000 tonnes. The global stock of gold being estimated as around 145,000 tonnes, the share of gold held in India would fall in the range of 7% to 10%.

The story of gold accumulation in India is as old as history itself. This is certainly not something unique to India - many of the ancient civilizations exhibit this feature. What is truly unique about India is the fact that at no time in history has India mined any substantial quantity of gold. In some old Greek texts (Herodotus, *The History of the Persian Wars)*, one can find reference to certain tribes in western India procuring sizeable gold from sandy deserts to finance war efforts. The current gold production per annum is around 2 tonnes. One of the gold fields in southern India operated by the state-owned Bharat Gold Mines Ltd (BGML) at Kolar has - Asia's oldest and deepest mines. This particular gold field is known more for its contribution to particle physics than for its volume of production, past or present: the conclusive evidence that sub-nuclear zero-mass particles in cosmic rays called *Neutrino* bombard the earth was found in experiments conducted in its deep pit.

Some have sought to explain the process of accumulation of gold in India in terms of cultural factors alone, but there appear to be very strong economic underpinnings for this phenomenon:

(i) India has enjoyed a continuously favourable balance of trade for eight centuries spanning the first and the second millennium AD, enabling it to import precious metals.

(ii) The inheritance laws in the Mughal period (1500 AD to 1850 AD) provided strong incentive for gold accumulation, particularly by the wealthy. Simply put, under the Mughal legal system, on the death of a person, the estate left behind would first compulsorily be vested in the state. The legal heir of the deceased would thereafter approach the state to gain the inheritance, which would be granted at the discretion of the authorities, on payment of duties to the state and possibly inducements to the officials concerned. This system engendered two obvious consequences: (a) conspicuous consumption by the wealthy and rich, and (b) the tendency to hide wealth from the eyes of the authorities. Gold, silver, diamonds and precious stones provided the means to convert savings into the most concentrated and indestructible form of wealth. This also facilitated easy and hassle-free transfer of wealth from one generation to another without state intermediation. The resulting historical experience of Indians has been deeply ingrained in their psyche. No wonder, the same tendency with regard to conversion of savings into gold is observable in good measure even now, although the law and the institutional

mechanism surrounding savings and wealth are very different.

(iii) In the Hindu, Jain and Sikh community, where women did not inherit landed property, gold and silver jewellery was, and still is, a major component of the gifts given to a woman at the time of her marriage. Jewellery, because of its easy convertibility into cash, is regarded as secure investment. Even among the nomadic and tribal communities, gold and silver jewellery are regarded as investment and identity markers.

(iv) For very poor people, gold can be held on the person for 24 hours a day, which eliminates safety concerns and also facilitates fleeing in distress. Gold can be mortgaged or sold in crisis.

(v) The advantage of gold vis-à-vis other financial assets is that at times of uncertainty the liquidity of gold actually increases.

According to the Bank for International Settlements (Annual Report, 1934-35), gold absorption in India between 1493 and 1930 was at least 14% of world production.

In one of the earliest research works on the subject (Rao, B S and Nagabhushanam, K (1960), *India's Demand for Import of Non-Monetary Gold, Non-Monetary Silver and Merchandise, 1901-1913*) it was empirically established that, during the period 1901 to 1913 (which was a sub-period of the gold exchange standard era 1898-1914), (i) gold demand exhibited higher income elasticity than both silver and merchandise, (ii) price elasticity for gold demand was negative, and (iii) gold was preferable to silver.

Gold Policy Since Independence

In the period following independence, the approach of mainstream economists and policymakers toward gold was marked by open hostility. Much like their western counterparts, Indian intellectuals were very much bothered by the 'artificialness' of the value of gold. Gold by itself, it was asserted, hardly adds much to production or productive capacity. Gold was seen as an illusion, a waste, contraband, a relic of the cultural and economic backwardness of the past. From an economic standpoint, the process of gold accumulation by the private sector in India was seen as resulting in loss of opportunities in two aspects, viz. diversion of household savings from productive assets and the consequent diversion of precious foreign exchange resources, adding to the chronic demand-supply imbalance on the foreign exchange market. Excess demand for gold was considered as one of the main reasons for the so-called external constraint, which hindered development and technological progress.

During most part of the period under the British rule, there was no restriction on movement of gold and silver into and out of India. The practice of metallic standards resulted in gold and silver flows for monetary and non-monetary purposes. Briefly, between 1717 and 1835, there was tri-metallism, involving gold, silver and copper. For the next 60 years or so, silver coin was the legal tender. The silver standard was

abandoned in 1892, almost twenty years after all major countries had done so. The gold exchange standard prevailed from 1898 until the outbreak of the First World War in 1914. During the First World War there was an attempt on the part of the government to control imported gold: this was annulled after the end of the War. During the Second World War, restrictions on import and export of gold were imposed, and prior permission of the Reserve Bank of India (RBI, which came into existence in 1935) was made compulsory for external trade in gold. Following the end of the Second World War, the wartime restrictions were withdrawn. However, this phase was brought to an end with the introduction of the Foreign Exchange Regulation Act (FERA) in 1947 by the new government of independent India shortly after assumption of office. By virtue of the provisions of this Act, a complete ban on exports and imports of gold was imposed. The restrictions in respect of gold fitted well in the policy regime in respect of the external sector, which involved a complex web of controls in respect of all external transactions. An interesting feature of the control regime was that it prohibited all transactions between residents and non-residents, unless specifically permitted. Gold was treated as a surrogate for foreign exchange, conservation of which was the main objective of the Act of 1947 and its successor legislation enacted in 1973.

The next important policy actions in respect of gold were undertaken in 1956, when gold mining/production facilities at Kolar in the southern state (province) of Mysore (subsequently renamed as *Karnataka*) was nationalised by the provincial government. This was intended to impose government control over gold production so that the government could directly acquire the gold output. That year is significant as it marked the beginning of an era of increasing state control over industrial activities in particular and economic activities in general in post-independence India. In the same year, the proportional reserve system (under which a minimum proportion of the currency liability was required to be covered by foreign assets, including gold) was abolished and replaced by a minimum absolute level for foreign assets for the RBI at Rs 2 billion for currency issue purposes. Also, the gold holding of the RBI was revalued in 1956. The RBI's gold stock was revalued once again in 1969 to reflect the effect of the 36.5% devaluation of the Indian rupee against the US dollar in 1966. Finally in 1990, an amendment to the RBI Act was carried out for marking the gold stock to market at regular intervals.

The policy approach toward gold was in tune with the objectives of self-reliance, planned development using domestic resources, and import substitution with reduced priority for external trade. Additionally, the policy on gold was intended to de-emphasize gold for the private sector, with the following objectives:

(i) To reduce demand for, as well as availability of gold.

(ii) To alter the savings preference of the population in favour of investments other than gold/silver.

(iii) To stop gold smuggling.

(iv) To prevent generation of black money/to unearth black money. It was

thought that since gold was one of the most obvious choices for keeping undeclared/ill-gotten income and wealth, a policy to restrict supply of gold would be effective in curbing black money.

(v) To conserve foreign exchange resources.

An important policy action with regard to gold was taken in late 1962 in the wake of a border conflict with China. Commercial banks were ordered to recall all gold loans (general-purpose short-to-medium-term loans, popular in the western and southern provinces) in November 1962, which coincided with the flotation of a 15-year 6.5% gold bond by the government, garnering 16.3 tonnes from the public. Concurrently, forward trading in gold was banned. This was followed by the promulgation of gold control rules by the government in mid-1963 which, among other things, banned production of gold jewellery/bars of more than 14 carat fineness. All jewellers, big and small, were subjected to record-keeping requirements as regards purchase, production and sales. Individuals/families were permitted to hold gold only in the form of jewellery, subject to quantitative ceilings. By early in the following year, government control over domestic transactions in gold was more or less complete.

Although in the next few years the 14 carat fineness ceiling requirement was relaxed to some extent, the control regime took a statutory shape with the passage of the Gold (Control) Act in 1968.

The first ever gold mobilisation by the government undertaken in 1962 was followed by two more gold bond schemes in 1965, which together collected 19.8 tonnes. An important feature of the issues was that immunity was granted to subscribers if the gold deposited represented unaccounted wealth. This feature was also present in a later mobilisation by the government in 1993, collecting a little over 40 tonnes, which reflected a long-felt view that a good portion of private gold holding represented unaccounted wealth, and hence sops were necessary to bring the stock into the open. In fact, this approach was given a statutory character in 1975 through an act of the Indian parliament which provided immunity to all disclosures of unaccounted wealth made in gold.

The gold bond issues from time to time reflected the fiscal motive of the government. The mobilised gold was used to raise rupee resources from the RBI. In the same vein, the government decided to sell gold from its own stock in 1977-78 by way of auctions in order to curb a rapidly rising fiscal deficit. However, the step faced a barrage of criticism and sale was abruptly stopped after only 13 tonnes were sold for Rs 870 million.

Economic Reform and Gold

The reform process triggered by the balance of payment crisis in 1990-91 resulted in a review of important external sector policies of the post-independence era. The restrictive policy on gold achieved very little in terms of its stated objectives. Large quantities of gold were routinely smuggled into India and the nexus between gold smugglers, the so-called

hawala operators, and perpetrators of high-profile crimes became common knowledge. The smuggling operation was so extensive that a few professional salvage companies in the west had looked at the lucrative prospect of salvaging substantial quantities of jettisoned gold lying in the seabed off the west coast of India.

The first major policy reversal in respect of gold came in the form of repeal of the Gold (Control) Act, 1968 in 1990. Subsequently, the provisions of the Foreign Exchange Regulation Act (FERA), 1973 (the successor legislation to FERA 1947) relating to gold were also repealed in 1993. The FERA treated gold and silver on the same footing as foreign exchange for exchange control purposes. Also, it empowered the federal government to impose curbs on use/disposal/dealings in gold and silver prior to or at the time of their import into India. More than an admission of failure to meet any of the prime objectives pursued in respect of gold, these steps symbolized a more realistic and a less ideologically charged approach toward gold.

The next major step was to allow returning non-resident Indians (NRI) to bring in 5 kg of gold as part of their baggage (subsequently raised to 10 kg) every six months on payment of duty at Rs 220 per 10 gm in foreign exchange. This step was intended to augment supply through official channels. The other channel for importing gold was by way of issuance of special import licenses (SIL) for jewellery export purposes only.

It is interesting to note that long before the advent of the reform in 1990-91, the gold control policy of the government was reviewed from time to time by committees appointed for this purpose, looking critically at most of the important aspects. One such exercise undertaken in 1978 examined the core restrictions of the Gold (Control) Act 1968 and recommended various relaxations. It also examined the question of issuance of more gold bonds by the government, but came out against this on the grounds that it would be inconsistent with the government's policy to encourage financial assets other than gold.

Gold came under policy focus and much media attention in the fall of 1991, when gold stocks of around 65 tonnes, (taken from the RBI as well as the government stocks) were taken out of the country for raising short-term foreign currency resources to tide over immediate external payment difficulties. Although this move came in for a lot of political criticism, with some equating it with 'mortgaging national honour,' most academics and policymakers saw in it a golden opportunity to make a fresh start on gold.

A discussion paper prepared under the aegis of the RBI in 1992 advocated mobilisation of private sector gold for external adjustment and removal of external constraints. It proposed the formation of a new government entity – the Gold Management Corporation (GMC) - for this purpose. Briefly, the GMC was thought of as the appropriate institutional mechanism for the transformation of huge quantities of private immobile wealth in the form of gold into productive capital for growth and development. An interesting feature of the discussion paper was that, although it was not sure about the commercial viability of the GMC, it nevertheless advocated its formation, stating that the economic advantages of the GMC, although not quantifiable, would far outweigh the commercial drawbacks. However, the government did not act upon the proposal.

The logic, as well as the momentum of the reform process, created conditions and provided the rationale for evolving a comprehensive policy framework with regard to gold.

Another significant policy shift that became apparent in the late 1990s involved the de-linking of gold from the government's antiblack money policy. The new fiscal stance with regard to black money centred on rationalisation of the income tax structure and the creation of incentives for revealing unaccounted wealth.

However, the Committee on Capital Account Convertibility (CCAC) made by far the most precise and action-oriented recommendations on the liberalisation of the gold market in tune with the broad contours of the reform process in early 1997. The CCAC rightly observed that gold-related issues were closely intertwined with capital account convertibility, and so liberalising the policy regime on gold must go hand in hand with removal of the remaining capital controls. The CCAC stressed that it was essential to liberalise the policy on gold while simultaneously taking steps to develop a transparent and well-regulated market in gold, which would be integrated with other financial markets. In its view, the main ingredients of the change in the policy on gold should be:

(i) Removal of restrictions on import and exports of gold, which it hoped would curb smuggling and hoarding.

(ii) Development of gold-related financial instruments.

(iii) Development of markets for physical and financial gold.

(iv) Encouragement of banks and non-banks to participate in the gold market.

As with other recommendations of the CCAC, the ones relating to gold were also time-sequenced. For Phase I, the main recommendation was to permit banks and non-banks fulfiling certain well-defined criteria to be allowed to operate freely in the domestic and international gold markets. This would mean that these entities would be allowed to buy and sell gold in the domestic and international markets without restrictions. Also they would be allowed to offer gold-related savings and loan products to their customers.

In Phase II (recommendations which were to be taken up for implementation in 1998-99, depending upon the progress made in achieving certain signposts relating to budget deficit, inflation, non-performing assets of banks etc) the development of the gold market in India would be enhanced through the introduction of forward trading and other gold derivatives.

The Phase I recommendations were acted upon quickly. In July 1997 the RBI came out with a policy statement laying down criteria for authorizing commercial banks to join the ranks of a few state enterprises like MMTC, HKDC, etc as nominated agencies for importing gold, silver and platinum. Initially, the nominated agencies were permitted to import gold for export purposes only. Later in the year they were allowed also to supply gold by way of sale and lease for domestic use under a form of restricted "open general licence (OGL)" terms. Both the number of nominated agencies (at present around 20) as well as the volume of imports through this channel increased significantly in the recent years.

In early 1999 the RBI permitted commercial banks to accept interest-bearing gold term deposits from public against physical deposit of gold. An interesting feature of this scheme is that the deposit receipts are negotiable and are intended for trading in the secondary market. The idea here was to introduce paper gold, which would satisfy the investment demands of those who seek to acquire gold as an inflation hedge, or those who simply intend to go long on gold. It was hoped that this would depress the import demand for physical gold.

However, this scheme has yet to take off, in the sense that the response from the members of public has not risen to a high level. Also, the deployment of gold mobilised by way of gold loans to jewellery manufacturers has also not picked up.

Yet another significant development in the reform process was the repeal of the Foreign Exchange Regulation Act (FERA) 1973 and its replacement by the Foreign Exchange Management Act (FEMA) 1999, which came into effect from 1 June 2000.

The enactment of the new legislation marked a tectonic shift, as it were, in the policy stance with regard to foreign exchange management, which is evident in its preamble: "...with the objective of facilitating external trade and payments and for promoting the orderly development and maintenance of foreign exchange market in India". This is in sharp contrast to the preamble of the FERA 1973, which reads "... for the conservation of foreign exchange resources of the country and the proper utilisation thereof in the interest of the economic development of the country". In fact, enactment of the FEMA 1999 marked the formalisation of the shift in the external sector policy in the reform era.

Demand for & Supply of Gold

To explain the ever-increasing demand for gold in India, various hypotheses have been put forward from time to time:

(i) Demand for gold has an autonomous character. Supply follows demand.

(ii) Demand exhibits income elasticity, particularly in the rural and semi-urban areas.

(iii) Price differential creates import demand, particularly illegal import prior to the commencement of liberalisation in 1990.

(iv) A part of the demand is caused by the need to stash away unaccounted wealth/income.

A look at the gold trade figures since the onset of liberalisation in 1990 shows that, while the price differential narrowed from a high of around 53.1% in 1991 to about 5%-10% currently (which reflects customs duty, transportation cost, local cess, etc), the import volumes rose unabated.

Gold demand in India increased by an annual compound rate of around 15% from 1990 to 1998 during the period of liberalisation, with growth slowing thereafter. This was high, not only vis-à-vis the world demand growth rate of 3.05%, but also in relation to the trend Indian GDP growth rate (5.5%) and the growth rate of demand for oil (3.8%), energy (6%) and sugar (5%), which exhibit high income elasticity. Equally striking has been the shift from smuggled to official imports. Gold Fields Mineral Services Ltd (GFMS) estimate that in 1992 smuggled imports accounted for 115 tonnes, over one third of total imports of 320 tonnes. In 1998, smuggled imports were estimated by GFMS at 56 tonnes, just 8% of the total import of 718 tonnes. Taking the gold import per year in the beginning of 1950s at around 90 tonnes, the long-term compound growth rate of import in the 51-year period (1950-2001) turns out to be 3.8%. In the recent past, year-to-year distribution of imports among official and smuggling channels responded to customs duty variation. Smuggled imports appeared to rise again after duty was increased in the 1999 budget but fell back after the duty was reduced again in the 2001 budget.

By value, gold import is the second most important item of import after fossil fuel.

Since 1997 there has also been changes in the form of official imports. Since the commencement of the non-resident Indian (NRI) route for import in 1991, there was criticism of this arrangement on the ground that most of the gold imported in this manner does not represent genuine earning/savings of the returning non-resident Indians. It was alleged that funds for this type of import, which thrived on account of differentials between domestic and international prices, were provided by diversion of foreign exchange resources of the country through the underground market (*hawala*).

There may be an element of truth here. But, in any event since the introduction of the restricted OGL arrangements in 1997 the imports of gold under NRI has effectively dried up. Gold imported officially for domestic use is now channelled almost exclusive via the official agents or the authorised commercial banks

Future Trends

What is the likely demand trend for the future? Given the fact that gold demand is income-elastic, it would be safe to assume that demand will increase over the next decade. Interestingly, serious work on assessing demand for gold has been going on in India for some years now. Since gifting gold jewellery at the time of marriage constitutes the major component of demand, a ball-park estimate could be made on the basis of the number of marriages that take place annually. On the assumption of around 8 million marriages per year, and on the basis of another set of assumptions regarding gold required for marriage by families of different income groups, one arrives at a figure of little over 900 tonnes.

Although this approach is appealing, one obvious difficulty in equating gold requirement with gold purchase demand arises out of the fact that it is common practice among families in India to begin accumulation of gold required for the marriage

of a female child right after the birth of the child. Nevertheless, such estimates provide some insight into this complex process.

It is true that gold is facing strong and growing competition from other investments and savings vehicles. With the spread of banking, even in rural areas, which absorb about 70% of gold consumption, there is anecdotal evidence that suggests that Indian families are increasingly opting for bank deposits and company shares as alternative items for gifts at the time of marriage. Recent empirical studies (Vaidyanathan, A, *Economic & Political Weekly*, February 20, 1999) have established that the price of domestic gold in relation to share prices is emerging as an important determinant of import demand for gold.

Gold Market in India

The gold market in India is predominantly a market for buying and selling physical gold. In the wholesale segment, nominated agencies are the bulk importers. This market is reasonably efficient from the point of view of distribution of bars and scraps over the length and breadth of the country, which takes place in a very effective manner. Price uniformity is also generally observable in areas with identical incidence of duties and tax.

In the market for ornaments and jewellery, consumer protection is still not assured, although it must be admitted that this has received much policy attention in the last few years. It is customary even now for the well-to-do in India to buy jewellery items abroad for better quality assurance. It is a well-known fact that cheating on caratage (fineness) is widespread. In April 2000, the government introduced voluntary hallmarking of gold jewellery through the Bureau of Indian Standards. However, the progress in this regard has been slow so far, with only about 335 jewellers having accepted the necessary certification with most of them having only partial stocks of their jewellery hallmarked. Also, there are only 11 assaying and hallmarking centres in the country.

Gold lending/leasing volumes are small in comparison to physical buying and selling. Most of the leasing activities are undertaken by nominated banks on a back-to-back basis via supply from overseas. Domestic lending resources are still meagre, as mentioned before. This segment of the market needs to develop for at least two reasons:

(i) To provide working capital at low cost together with gold price hedging, not only to the exporters but also to jewellery manufacturers for the domestic market. At present, non-exporters do not receive the necessary working capital finance in rupees from the banking system. The evidence of the significant contribution made by the spread of gold leasing, even to small family jewellery units, in boosting exports and local sales in Italy could provide guidance in the matter.

(ii) The existence of a gold lending/leasing market is a pre-condition for arbitrage-free pricing of gold forward/swap contracts in the local market.

Enhancing lendable gold resources by banks will be a major challenge. Innovative

deposit products, backed by effective marketing strategy, will be the key. However, the response of households is likely to be slow.

There is at present no legal obstacle to forward trading in gold by the nominated banks. At the time of introduction of the gold deposits scheme in 1999, notification for exemption from the provisions of the Forward Contracts (Regulation) Act 1952 (which prohibits forward trading in commodities, including gold, unless exemption is allowed) was issued by the government in terms of Section 27 of the Act itself. This cleared the deck for banks operating gold deposit schemes to engage in forward contracts in overseas markets or amongst themselves for the purpose of management of gold-price related risk on their balance sheets. However, the legal ban on forward contracts in respect of others, like jewellery manufacturers, continues. It is hard to guess if and when the general ban on forward trading in gold will be lifted, but if the recent lifting of the ban on forward trading in agricultural commodities is any indication, it is possible that the measure will be extended to gold in the near future. There is a history of active gold futures markets operating in India from the end of the First World War until the imposition of the ban on forward trading in gold in 1962.

Issues for the Future

It would only be logical to assume that the need for a review of the overall policy stance with regard to gold is now being increasingly felt in official circles. As with other areas of liberalisation, the direction of change will certainly be positive, although it would be difficult to imagine any specific time-frame. However, the following issues are likely to be the focus of policy:

1. Strengthening of the infrastructure and market in physical gold. More assaying, refining and recycling capacities of international standard and accreditation are expected. Technological collaboration with established international names is sure to occur.

2. Better protection for consumers, by way of the spread of hallmarking of jewellery. The emphasis will continue to be on more self-regulation by jewellery manufacturers and retailers.

3. Further liberalisation of the gold import regime is a live issue. Removal of all the remaining restrictions on gold imports has been advocated by many on the following grounds: in Indian legal parlance this would mean placing gold under full Open General License (OGL) enabling anyone to import gold for any purpose:

(a) Trade liberalisation for gold is a pre-requisite for financial liberalisation.

(b) There is no specific advantage in restricting gold imports to a select number of nominated agencies.

(c) If gold is imported freely under full OGL, fiscal benefits will accrue to more provincial governments and local bodies than at present.

(d) Going by the Turkish example, free imports under full OGL and free export are pre-conditions for establishing a foothold in the world jewellery market. Partial liberalisation of imports in India since 1990 has indeed led to growth in jewellery exports.

Arguments in favour of continuing with the existing arrangements, at least for some more time are:

(i) It would not be prudent to put gold import under full OGL without first assessing the possible adverse impact on the balance of payments.

(ii) There is hardly any excess demand in the country now, with the price differential reflecting customs duty and local taxes.

(iii) Bulk import through nominated banks affords better monitoring and control over wholesale gold market. Gold transactions can be better tracked, and ceilings on gold import, if necessitated for any reason, can be imposed with better effectiveness. In the transition period, pending full import liberalisation, this arrangement is best suited.

However, in the interim, i.e. before eventual full import liberalisation, it is possible that the government will do away with the requirement of payment of duty in foreign exchange for the NRI route.

4. Regulation of the physical and financial markets in gold is another major issue. Regulation in general means formulation of norms (followed by surveillance in respect of observance thereof) by the regulator for (i) risk assessment and control for the regulated institutions, and (ii) investor protection.

Certain developments in the last few years have highlighted the risks for nominated banks in dealing in physical gold. Risks associated with gold banking are beginning to be felt. It is time a regulatory mechanism for the physical market is put in place. Here again, the past could provide a good guidance - it would be worthwhile to examine, among other things, the self-regulation practised by the Bombay Bullion Association in the past.

As regards the regulation of gold banking, it would be efficient to integrate it with the regulation for other activities. As regards investor protection, first and foremost the legal character of all gold-related instruments needs to be defined.

5. Bringing the gold held by the private sector into the economic mainstream has rightly been an objective throughout. Mobilisation of gold by the government in the past did not yield any major long-term benefit. Any government-led mobilisation has inherent disadvantages. A better alternative would be to allow holders of gold to raise capital from the banking system by way of pledge. It would be inconsistent with the spirit of liberalisation to discriminate against those who saved in gold in the past. Moreover, there is no *a priori* reason to believe that borrowing against gold will be predominantly for unproductive purposes, like speculation, etc. A mechanism can be evolved whereby banks lending in

rupees against gold would be able to borrow in foreign currency in the international markets using the same gold as collateral. This would serve the purpose of raising external resources, should there be a need for this. The advantage of this arrangement is that it is market-oriented, price-based and decentralised.

6. If development of e-money in the west is any indication, it is possible that a private sector unit of account that is linked to gold may come into existence in India, given the facts of huge private sector gold stocks, India's tremendous progress in the IT area, and the fast spread of Internet in the country. The demand for private alternatives as regards store of value/medium for transaction is growing in some countries. It would be advantageous to look into this possibility.

7. Does gold have any official monetary role left in India? Not much in a formal sense. Long before the demonetisation of gold in the international monetary system in the post-Bretton Woods era, gold's role in currency issue was brought to a level of insignificance in India. The *de jure* position for the last 45 years is that for gold backing against currency issue, there is a minimum level prescribed, which is quite modest at Rs 1.15 billion. The *de facto* position is that gold has been maintained at a much higher level, currently at around 360 tonnes. At the current level of currency in circulation, gold provides a backing of approximately 6%.

There is good evidence to support the view that gold is held as an inflation hedge in India. This is not surprising because inflation, as it affects the vast majority of the Indian people, has been highly unpredictable. Demand for gold is likely to contain information regarding inflation expectations. Since monetary policy is reflected in the growth of money stock and, ultimately, the rate of inflation, there is a case for including gold in the monetary calculus. It needs to be examined whether there is any advantage in including gold held by the private sector in the broad measure for liquidity, even though gold is not anybody's liability. Also, gold could be included in the index for the real effective exchange rate for the rupee. There are indications that, other things being equal, gold import demand has a relationship with the real effective exchange rate of the rupee.

An interesting aspect in this regard is that, while the authorities have pursued policies to de-emphasize gold and to suppress demand for gold, the balance sheet of households showed more gold on the asset side. Over the last three decades or so, the additions to the gold stocks held by households constituted around 20% of the increase in their financial assets, although on a year-to-year basis, this number has been very volatile. This happened at a time when the currency liability of the RBI was backed mostly by the debt obligations of the government. Clearly, gold was ahead in competition with money and quasi-money, which had adverse implications for interest rates and the seigniorage earnings of the RBI. Does the preference for gold reflect a choice in favour of a more stable asset vis-à-vis money and bank deposits?

It is a known fact that even in the present age of fiat money enforced with coercion, currency competition is a fact of life. Consumer preference, even with regard to the choice of medium of exchange/store of value, has its own way of expressing itself, no matter what the legal and other restrictions.

Epilogue

In conclusion, it would be worthwhile to recount the following historical trend in monetary arrangements the world over: since the dawn of history until recently countries followed commodity standards and, more specifically, bi-metallism. The abandonment of the gold standard also saw the proliferation of national monies and establishment of national central banks/note issuing authorities, currency being a symbol of sovereignty. This coincided with the establishment of nation states in post-colonial Asia, Africa and Latin America. However, the process for monetary unification also began in Europe after the break up of the Bretton Woods system. Countries with currency board arrangements/fixed exchange rate system still retain the power of note issue in a nominal sense of the term, as they do not conduct independent monetary policy. In a globalised world, there is bound to be preference for a much smaller amount of fiat money than at present.

In the event of monetary unification for the whole world, what will constitute the reserve asset? Gold, undoubtedly - but achievement of monetary union for all nations sounds very much like discovering El Dorado.

Notes

Notes

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