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   INTRODUCTION

   REVIEW OF LITERATURE

   NEED/IMPORTANCE OF THE STUDY

   STATEMENT OF THE PROBLEM

   OBJECTIVES

   HYPOTHESES

   RESEARCH METHODOLOGY

   RESULTS & DISCUSSION

   FINDINGS

   RECOMMENDATIONS/SUGGESTIONS

   CONCLUSIONS

   SCOPE FOR FURTHER RESEARCH

   ACKNOWLEDGMENTS

   REFERENCES

   APPENDIX/ANNEXURE

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# THE ECONOMIC RATIONALE OF GOLD IN INDIAN CONTEXT

*DR. M B MOHANDAS*
*MANAGER (COMMERCIAL)*
*IFFCO LIMITED*
*NEW DELHI*

**ABSTRACT**

*As the ever growing demand for gold gradually started to exert tremendous pressure on India's external balance, government initiated an array of measures to curb the imports. Since independence, the domestic gold market was regulated through Gold control Act. From the 1990s reforms it is increasingly liberalized. As the internal availability is very limited, most of the consumption demand is generally met through imports. Today it stands second in the import basket. Despite a slew of trade and exchange rate policies, current account deficit run into trouble. This paper attempts to identify and pinpoint various influential factors on demand front and also ascertain the impact on the external balance The study is exploratory and broadly qualitative in nature based on review of mainly RBI and World Gold Council (WGC) studies engaged with both primary and secondary data. The results are quite surprising. Possession of gold is a symbol of social status, wealth and prosperity. It has emotional, cultural and financial value, which supports demand across generations. Gold is an integral part of the Indian lifestyle and is the only saviour during distress period. Gold demand is price inelastic. But higher imports have adverse impact on external balance. After all, Indian life is enshrined with gold.*

## JEL CODES
E21, F13, F32, F34.

## KEYWORDS
Gold demand, Current Account balance, Forex reserve.

## INTRODUCTION

In order to curb the ravenous appetite to gold, during the period January, 2012 to August, 2013, Government of India has hiked import duty on gold which was kept ludicrously very low in 2002-03, from 1% to 10% in 5 steps. On the quantitative front, RBI, the central bank, imposed the 80:20 formula under which 20% of total imports should be re-exported through value addition in the form of jewellery. The bulwark against gold imports which has turned the second biggest import after oil, was intended to trim down the current account imbalance from $88 billion in 2012/13, or 4.8% of GDP, to $70 billion, or 3.7% of GDP, by close of 2013/14 as the gold trade can get gridlocked over the rupee free fall and Current Account. Since post independence gold import and export was banned under the Foreign Exchange Regulation Act (March 1947). The domestic market was meticulously regulated through Gold Control Rules and the Gold (Control) Act enacted in 1968. Accordingly, private ownership was restricted to jewellery and coins already in circulation. Owning bars became illegal and fabrication and retails fell under license raj. The manufacture of minted bars and medallions was forbidden along with forward sales. After 27 years, the Gold (Control) Act was rescinded with the economic reforms initiated in 1990s. Since then the exchequer has unleashed pragmatic policies crafted to augment the share of gold imports, stimulate value added the exports, improve the overall quality and persuade the recycling in private hands the Gold Deposit Scheme in particular. Important initiatives include the introduction of official gold import schemes, notably the Non-Resident Indian (NRI) Scheme in 1992 and the authorisation of banks in 1997, the Gold Deposit Scheme in 1999, the hallmarking initiative in 2000, and on-going support for gold jewellery exporters. Thus in order to meet the ravenous domestic appetite, imports have been judiciously liberalised as the domestic resources are very limited and minuscule in comparison with demand.

## REVIEW OF LITERATURE

It can be palpable that throughout human civilisation, gold has graciously fulfilled all the three currency criteria: unit of account, store value and medium of exchange. Further, it has played pivotal roles in the international monetary system as a unit of exchange and a monetary anchor. But, after the collapse of the two main pillars of Bretton Woods System, namely the fixed exchange rates and convertibility of dollar into gold and the subsequent evolution of floating exchange rate regime, its official role has consistently moderated. However, in the second quarter of 2009, central banks turned net buyers for the first time in two decades and have continued to purchase since then mainly due the deteriorating credit quality of government debt. More precisely, it always stands as a natural hedge to today's all fiat money circulating across the continents. Though the worldwide acceptance, liquidity and safe haven against any economic misfortune or political mayhem makes gold lucrative, its value addition to the economy is minuscule. Universally, gold has emotional, cultural and financial value, which supports demand across generations.

In the post-war (World War II) period many national economies had become more open and foreign trade expanded at a faster pace than the world output. Further, many insular and controlled economies gradually abandoned their conventional import substituting industrialization model and started advocating and adopting outward oriented development strategy with explicit export orientation. More precisely this involved a clear shift from state controlled public sector dominated economy to private sector centric market led economy. Another striking aspect during the post-war era was the emergence of three distinct major regional economic groupings namely East Asian, North American and European. International trade increased at a faster rate than the GDP growth of individual national economies.

Brisk growth in foreign trade in goods, services and finance plus the predominance of new technologies and innovative modalities for production as well as marketing via the proliferation of MNCs were the visible features of the globalization process – integration of capital, labour, management and the rapid movement of goods and services with the rest of world. Under the new scenario, independent monetary policy and free capital movements became inconsistent with rigid fixed exchange rate. Since the Gold Standard era, diverse international financial systems have attempted to achieve combinations of two out of the three policy goals. The Bretton Woods System sacrificed capital mobility for monetary autonomy and exchange rate stability. The Euro system is built upon the fixed exchange rate arrangement and free capital mobility, but abandoned monetary autonomy of the member countries. For many years until recently, developing countries had pursued monetary independence and exchange rate stability, but kept their financial markets closed to foreign investors. The fact that countries have espoused combinations of two out of the three policy choices and altered the combinations as a reaction to crises or major economic events must mean that each of the three policy options is a mixed bag of both merits and demerits for managing macroeconomic conditions. (Joshua Aizenman, Menzie D. Chinn, and Hiro (November 2009) No 180. Today, Exchange rate movements are not generally governed by national price level movements but rather by the weight of the capital flows and the consequent intervention policy of the central bank. Macroeconomic stability and the incentives to engage in trade, in short and medium terms, began to revolve around the concerns related to real exchange rate stability.

## METHODOLOGY USED IN THE STUDY

The study is exploratory and broadly qualitative in nature based on review of mainly RBI and World Gold Council (WGC) studies engaged with both primary and secondary data. Primary data have been garnered by partially structured open ended interview schedule. Whereas the secondary data from internet, journals, articles, etc.

## OBJECTIVE OF THE STUDY

The main objectives of this research paper are:

1. To identify and focus the various influential factors on the demand front in Indian context
2. To ascertain the impact of gold demand on the external balance of the economy.

## SIGNIFICANCE OF THE STUDY

Post-Independent India under centralized planning witnessed a low growth rate of meagre 3% characterized with high unemployment and a worsening balance of payment situation. The trade regime was characterised by high nominal tariffs and non-tariff barriers coupled with a complex import licensing system. In short Indian economy remained insular till late 80s. Finally without having no other choice, except to embrace the free market ideology to get out of the quandary and forced to shed the path of "Nehruvian socialism" and took a U turn towards a more open and liberal economy by putting an end to the 'license permit Raj'. Reforms lifted India towards a high growth trajectory from the sluggish Hindu growth rate. The economy got diversified significantly, the share of Service sector in employment generation has been consistently rising, booming financial sector and huge foreign inflows strengthened corporate sector which in turn contributed to vibrant trade and commerce and the overall living standards of an average Indian got a boost.

In an open economy, trade can take place among countries, only when they are mutually benefited. Thus an open economy is equally concerned with its internal and external balances. Internal Balance requires full employment and low inflation or domestic price stability, more precisely internal value of home currency. External Balance is attained by a net current account balance and sufficient Forex reserve for meeting unexpected economic misfortunes. When a country's productive resources are fully employed and its prices are stable, it is in internal balance. So a country engaged in foreign trade is always closely monitors its unemployment, domestic saving, Trade imbalance and money supply and the price level. Internal Balance is managed through Fiscal & Monetary policies and whereas External balance with Trade & Exchange rate policies.

## FINDINGS AND DISCUSSION

### ECONOMICS OF GOLD

Since time immemorial, gold has mystique and mesmerizing record due its brilliant colour, glistening sheen, corrosion and tarnishing resistance. Its scarcity, eternalness and difficult to counterfeit adds value and may be the only safe and trustworthy wealth accessible to one and all throughout prehistoric, ancient, medieval and modern times. It is the best all time safeguard against any political and economic turmoil and hence it has always considered as a highly coveted product. India, the largest consumer of gold, accounts about one fourth of the total global consumption where around two third flows to jewellery industry which is valued presently at about $40 billion and driven by an assortment of cultural, social, religious and demographic factors. Hence it pervades every echelons and class of the Indian society where it is equally sought by wealthy urban population or poor village farming community. Some independent estimates show that about 65 per cent of the domestic gold stock is held in rural India where 70% of the 1.25 billion population reside and 40% of annual consumption absorbs in the southern states. It is worth to note that the large chunk of Indian heavy demand is met externally, through imports as internal resources are very minuscule in quantity.

### TRADITIONAL FACTORS

Like in most ancient civilizations, traditions have significant and profound influence on Indian society. Possession of gold is a symbol of social status, wealth and prosperity. Part of the small rural earnings is stored in trinkets as a safest all time wealth. Gold plays an indispensable as well as indisputable role in weddings. Indian brides are in fact festooned in gold jewellery which endows them with financial strength, eminence and insurance in their new home. The more and more women employment opportunities emerging from the various poverty eradication missions through women empowerment initiatives and women employment opportunities in large consumer wholesale and retail showrooms, Malls, Textile and jewellery showrooms, IT and IT enabled services have propelled the women purchasing power of gold to a great extent. Throughout the country, most of the festivals are celebrated with gold. Today, felicitations and in important family occasions by gifting gold jewellery or coins are deeply ingrained in all ranks. Some days, notably Dhanteras (2 days before Diwali) and usually Akshayatritiya (in May) are viewed as very auspicious to buy gold. Further, many event and lottery prices / Jackpots are offered in gold. The large portion of rural household savings is in jewellery from. Usually, a family's gold will only be sold as an absolute last resort and/or in dire emergency. *It should not escape notice that gold and silver, after circulating in every other quarter of the globe, come at length to be absorbed in Hindostan, from Travels in the Mogul Empire By François Bernier, the famous French traveller* (1625 – 22 September 1688*, Irving Brock.* The above words underscore Indians deep affinity to gold.

### RELIGIOUS FACTORS

Gold is an auspicious metal, presumed to be divine and considered as bringing the Goddess Lakshmi into home. Gold is an inevitable item in many rituals. Idols in temples generally are adorned with gold. It is a common scene that the roofs of Sanctum sanctorum of many temples are covered with either gold sheets or gold plated. It is common that in the thanks giving process, devotees profusely offer various articles made up of gold to temples against favours received. Many ancient and important temples have rich gold stock, for instance, Tirupati Trust has well over 1000 tonnes. In 2011, a massive treasure trove was unearthed at Sri Padmanabhaswamy temple, Kerala.

### MONETARY FACTORS

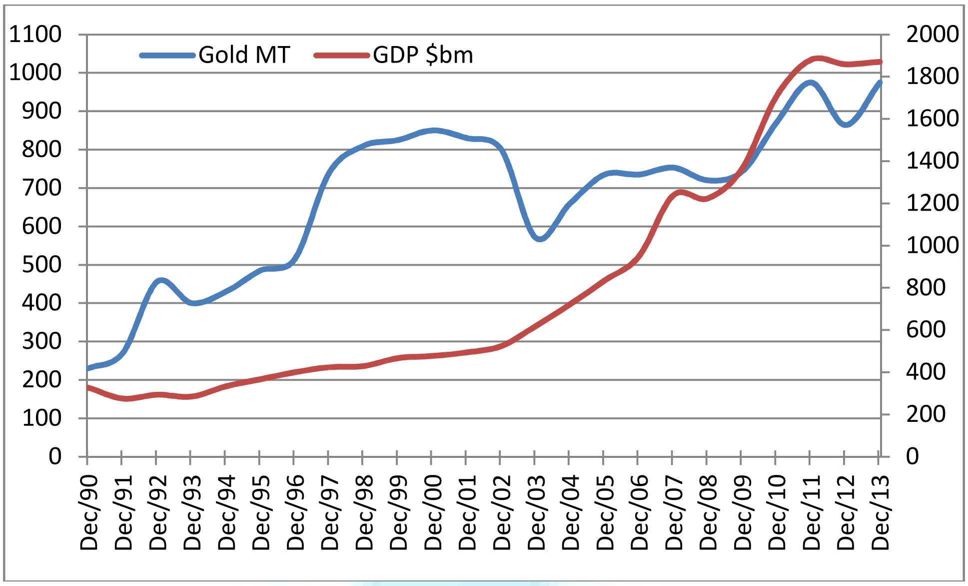
The alluring attraction of gold is its high degree of Liquidity quotient. More precisely, gold can be encashed with in no time which can't be attributed to any other prevailing financial / investment instruments as redeeming usually takes time. It is a common practice among the rural household's mindset that gold is pawned, bought back and re-pawned to manage the unforeseen economic misfortunes. Pledging jewellery and other gold assets to secure loans to local pawnbrokers and money lenders is prevalent in the Indian society over ages as fitting substitutes are virtually absent. It is reported that only one fifth of rural India has access to formal financial sources. Though the millions residing in the rural are far away from modern financial engineering, they know that gold is a conventional unit of account and will continue to remain ever unless it is abundantly available and a prolonged slump in value. So they will keep on buying though even if just little and pass on to the next generation as it will be helpful in dire times.

When India faced its worst ever balance of payment crisis in 1991, the official gold reserve came to rescue by way of pledging 67 tonnes from the official reserves to Union Bank of Switzerland and Bank of England and raised $605 million to shore up its declining foreign exchange reserves. Keeping the above in mind, in the midst of global financial meltdown, the Central Bank (RBI) in compliance with its foreign exchange reserves management operations, has procured 200 tonnes of gold in October, 2009 from IMF at a value of $6.70 billion, under the IMF's limited gold sales programme. It is pertinent to note that at the time of Independence, official reserve was 243 tonnes from which it gradually went up to 357 tonnes in 1998 and after the above deal it closed to 557 tonnes.

In view of above facts it is apparent that gold demand is in the vortex of various socio, economic and cultural factors and hence Indian are emotionally involved to accumulate gold. Further, the demand is seasonal which would be peaked during festival and marriage times (September to March) and is price inelastic.

**GOLD DEMAND & GDP**

FIG. 1

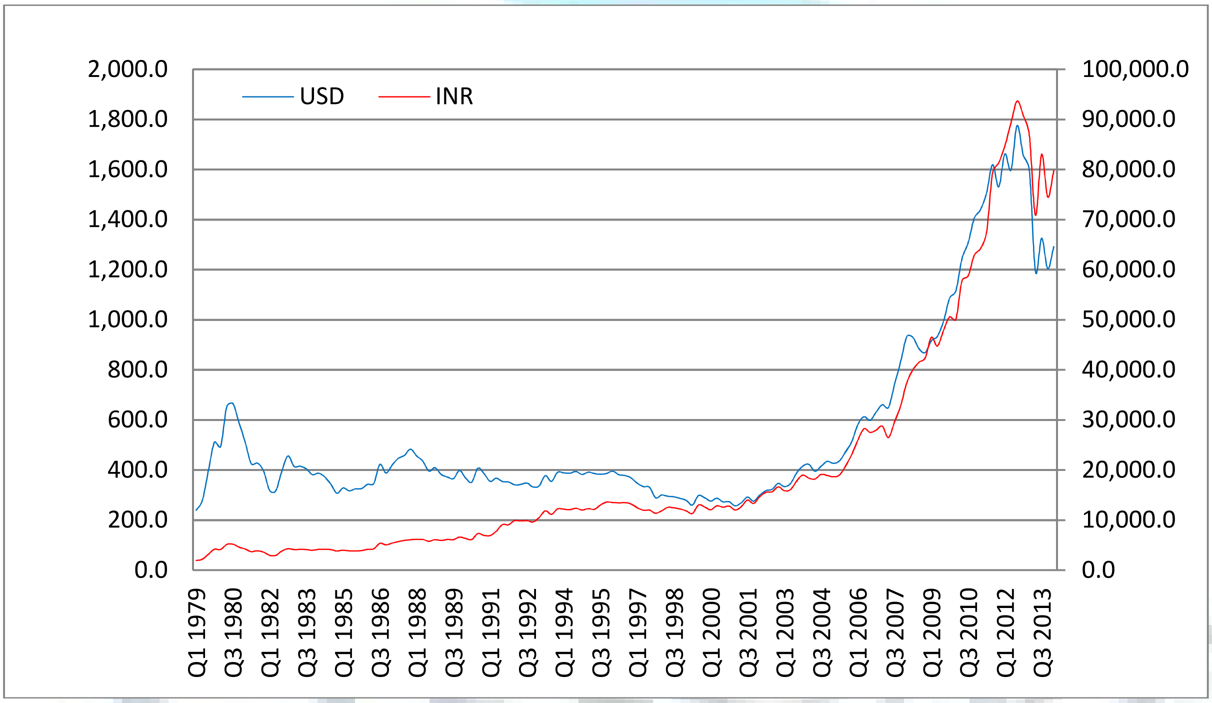



Source: RBI, IMF WEO2014 and World Gold Council (X axis: Gold in LHS & GDP in RHS respectively)

Under restricted regime, the annual consumption of gold was merely 65 tonnes in 1982 which inched just over 200 tonnes in 1990. From the above diagram, it can be perceived that since the beginning of economic reform, gold persistently rallied more or less in tandem with GDP growth and today it edged to almost five fold! In the first seven years (1990-97) rally, the consumption touched to 700 tonnes. During 2002-2012 periods the annual demand stood reasonably stable in the range of 700 to 900 tonnes regardless price which shoot up from Rs. 13,350 to Rs. 86,950 per troy ounce. Or in other words, $1.8 trillion Indian economy absorbs one fourth of the global demand, about 4,000 tonnes. Though there is no exact stock at finger tips, estimate says that Indian gold stock accounts 30,000 to 35,000 ton. At the same time, GDP which was $325 billion in 1990 rose to $1.8 trillion in 2013.

**MOVEMENT OF GOLD PRICE**

FIG. 2



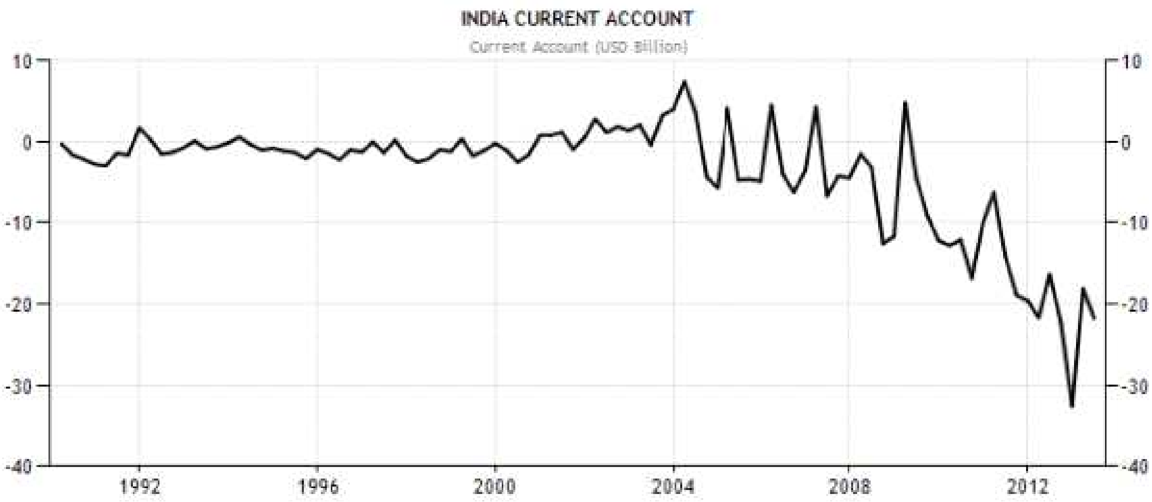

Source: World Gold Council (X axis: USD in LHS & INR in RHS respectively)

During the first decade of liberalisation (1990-2000), the gold price in overseas crawled back to $275 per troy ounce from $360 and climbed to $520 in between 2000-2005. Then it was doubled in the next four years. In the next stretch, that is during 2009 to 2012 it zoomed from $1050 to $1700 and then slowly inched to below $1300 as on today. Whereas the gold price in the domestic market was almost doubled in same periods. That is from Rs 6,350 per troy ounce in 1990 to Rs 12,800 in 2000, Rs 23100/- in 2005, Rs 50600/- in 2009 and now at Rs 74500/-. But after global meltdown, both prices are moved in the same magnitude. Despite a fourfold rise in the rupee gold price over the last decade, gold demand continued to grow. It is also pertinent to note that since the big ticket reform initiatives the domestic unit continued to depreciate under the heavily managed float.

**IMPACT ON EXTERNAL BALANCE**

Since 1991 India like other emerging market economies gradually abandoned its conservative import substituting industrialization model and started advocating and adopting outward oriented development strategy with explicit export led growth.

FIG. 3

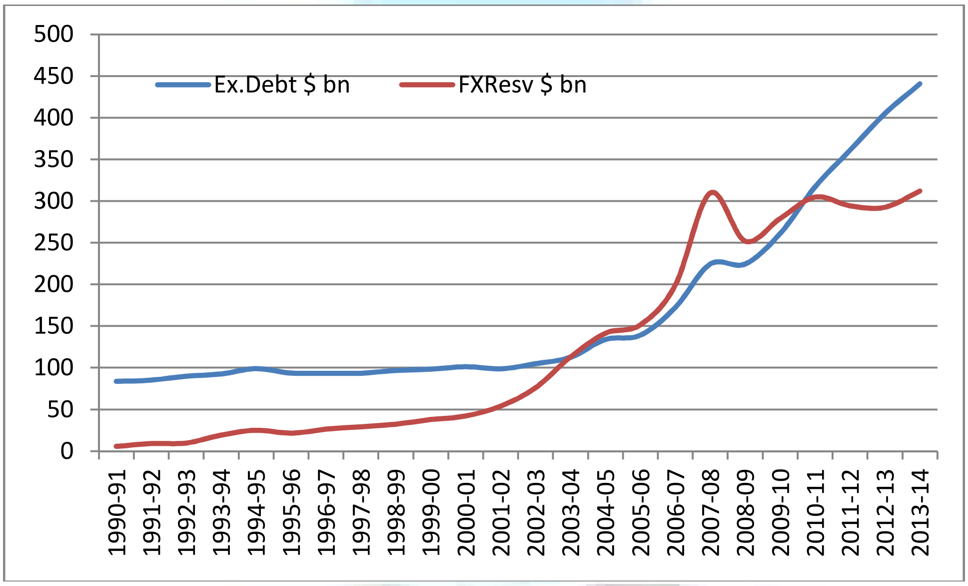



Source: RBI Data

It is evident from the above chart that though a slew of Trade and Exchange rate policies are unleashed, current account ran into rough weather throughout the post reform period barring three years. The current account deficit (CAD) is relentlessly compelled to finance from capital inflows (account). Thanks to the long prevailing overseas low interest regime! Even the weak domestic unit desolately failed to rescue the increasing CAD. Hence it can't be undermined that in reality, India's forex reserve is accumulated through external borrowings (a borrowed one) rather than earned from exports or not from Current Account Surplus. During the last decade, both external debt and forex reserves are zoomed in tandem. In the above scenario, the external front is more and more vulnerable from both ends.

**INDIA'S EXTERNAL DEBT & FOREX RESERVES**

FIG. 4




Source: RBI Data

Gold is the second largest component of import basket, after crude. Crude keeps on the economy running. The large and ever growing gold demand wields more pressure on current account balance. As the domestic production is trifling and the resultant large imports directly contribute to the widening of the current account deficit. Again it has to be paid from its borrowed reserves. Thus, the high gold imports and the weak rupee have been the biggest stress points when it comes to narrowing the current account deficit. Hence huge and ever increasing gold imports can derail the external sector through current account.

## CONCLUSION

Across the country, gold has emotional, cultural and financial value that supports demand across generations. It is the only item that permeates every strata and class. Gold is an integral part of the Indian lifestyle and is the only saviour during distress period. Gold demand is price inelastic. But higher imports have adverse impact on external balance. After all, Indian life is enshrined with gold.

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