Address by Smt. Usha Thorat, Chief General Manager, Reserve Bank of India on Development of Gold Market in India

Speech of Smt. Usha Thorat, Chief General Manager, Department of External Investments and Operations, Reserve Bank of India at the World Gold Council, New Delhi, on Saturday, August 2, 1997.

Development of Gold Market in India

In the last year's conference organised by the World Gold Council as also this year's, a number of issues have been raised which would lead to the conclusion that gold could play a very significant role with a more open policy on gold, rationalising tax laws pertaining to gold, ensuring quality control and allowing the financial sector to meet adequately the needs of this sector in terms of savings, financing and hedging products. I will therefore confine myself to the need for development of financial markets/instruments in gold and the steps that are necessary to facilitate the development of such a market.

I will try to make my presentation in the form of answers to few questions which are often raised.

If imports are further liberalised and taxes reduced, will the consumption of gold increase enormously as has happened in the period since the NRI route was opened up?

This question is not unfounded as the appetite for gold in India is prodigious. This is partly due to the cultural factors but mainly due to economic reasons viz. as a liquid safety net and hedge against inflation and due to a significant part of the demand for gold being unaccounted money. The rationale for a more freer regime as advocated by the Committee on Capital Account Convertibility is that despite rigid controls, the appetite to hold more gold is fulfilled. Thus, rather than driving the market underground, having a well regulated and functioning market will facilitate the gold economy to come on its own. Gold has its own value, but more than that, the important linkages of gold with the real and the external sector, which encompasses a whole array of economic activities, enhances its role which it could play in the overall development of the economy. Simultaneously, the long term strategy should be to ensure that the rupee is stable in terms of its internal and external purchasing power- thereby diminishing the demand for gold as an inflation hedge as has been amply shown by the global trends. The Bank for International Settlements (BIS) Annual Report for 1997 notes that as inflationary expectations have fallen around the world, not least in the US, the price of gold has shown less and less sensitivity to the movements in the US$/DM exchange rate. Secondly, as income levels increase there is bound to be some increase in the demand for gold and this is the phenomenon we have been witnessing of late. It is critical in such times that the financial markets reaches out to all sections of society offering both savings and loan products in a hassle free manner; this will further ensure that gold is not held in physical form as a liquid safety net. Thirdly, the liberalisation of the economy , the move towards capital account convertibility (CAC) for residents, the convergence of the tax regime to international levels and stricter enforcement of the easier tax laws will go a long way in curbing that part of the demand for gold which is for evading controls. The answer to the question therefore is that we cannot rule out some increase in the demand for gold on opening up, however, the advantages to the economy far outweigh the outflows of foreign exchange that would take place. Some outflows at this stage may counter the capital inflows that are taking place.

Why is the development of financial market in gold necessary to ensure that the industry fulfils its due role in the economy?

Financial markets in gold have developed in the world after the freeing of controls over the physical movement or holding of primary gold and this happened mainly after the world moved off the era of the US dollar's convertibility into gold. The increase in gold prices in the seventies made new mining technology cost effective. The business cycles in the different countries, the inflation rates and the movement in the exchange markets led to volatility in the price of gold leading to a natural demand for derivative products. The derivative markets are used by mining companies and dealing banks to support hedging operations and to finance exploration and extraction activities; by jewellers, refineries and manufacturers to fund their operations and by commercial banks and dealers who operate in these markets.

The London Bullion Market Association (LBMA) recently reported that the clearing turnover in gold in the London market in late 1996 was equivalent to about US $11 billion per day. Most of the trading was spot with a significant forward and option market. The high trading volume reflects the propensity of gold producers to lock in their output prices by selling their gold forward . The lack of an upward trend in gold prices may spur such selling but so does the less speculative desire by producers to reduce the volatility in their cash flows in order to improve their access to credit. The banks which buy forward from the producers hedge themselves by borrowing gold and selling in the spot market. The central banks are the major lenders of gold accounting for 75 per cent of the gold loaned estimated at around 2,750 tonnes at the end of 1996. All this ensures that the final product that reaches the consumer is priced most efficiently and is not too volatile.

What role can we expect the financial markets in gold to play in India?

Ultimately, the development of the gold market should ensure that the final customer is provided a price for the gold close to the international price. The customer should be able to liquidate her holdings very quickly with very little loss of value other than the movement in the spot price in perfectly legitimate deals. She should be able to borrow against gold at very low margins and at rates aligned to formal markets. There should be products as good as gold which may not result in any delivery of gold but offer all the features of gold viz. a liquid asset which serves also as a hedge against inflation. All this require the growth of a financial market in gold A concomitant development of the cash market is the growth of the derivatives market. A person planning to buy/sell gold in future would like to buy an option or a future to lock in on the prevailing price without parting with any cash at time of the contract - other than the futures margin or the option premia. For the jewellery manufacturer the development of financial and derivatives market in gold will enable him to hedge himself against the uncertainty of the price of his raw material viz. as gold also provides him with working capital finance. For the banks lending to such a jeweller the risk on account of uncertainties in the cash flow of the jewellery manufacturer due to price fluctuation is reduced if the borrower takes advantage of such hedging products.

How do we go about developing the financial market in gold ?

Phase I

The liberalisation in the policy on gold with the objective of developing a transparent and well regulated gold market as suggested by the Committee on CAC needs to be seen along with development of the financial products related to gold and the integration of the other financial markets in the country viz. money, securities, forex and capital markets with that of gold market. In this context, it would be useful to examine the Phase I recommendations. I am sure that these could be discussed in detail during the course of the workshop planned for tomorrow.

1. The Authorised Dealers (ADs) could be allowed to offer gold-denominated bonds/deposits and loans carrying a nominal rate of return. This would enable an investor to get the benefit of having invested in gold besides earning a reasonable rate of return. The settlements of these deposits could be done in rupee terms only. There is no prohibition on offering such a product at present. This product is on the lines of the dollar denominated savings and loan products recommended by the Committee. The question is how do the banks hedge themselves . To the extent that the deposits and loans are not matched the banks would need to hedge the gold /rupee risk by splitting into the dollar/rupee risk and the gold /dollar risk and it would be necessary to allow banks to hedge the gold/dollar risk in the international markets and the rupee /dollar risk as normally done and within the prudential norms stipulated by RBI.
2. Considering the vast volumes of private gold holding in the country, schemes could be formulated to attract this gold in the form of either gold, dollar or rupee deposits carrying corresponding interest rates. The settlement would be in the rupee equivalent of gold or dollar on the maturity date. Where the investor chooses he could have the delivery in gold as well. Banks should be able to deploy the gold so mobilised either by way of gold/gold denominated loans to the industry or swap into dollar or rupees for lending or investing in these currencies. When lending these resources in either rupee or foreign currency form, banks open themselves to the risk of gold price fluctuations and banks would therefore be an important player in the derivatives market. There is also the need for instituting effective risk management systems in banks for gold and gold related products on the lines of currency/interest rate risk management.
3. Gold Accumulation Plans (GAPs) could provide interesting savings instrument especially for Indian middle class. This could be operated on the lines of those in Japan, which could encourage the small investors to invest in physical gold without the at tendant problems of storage and security. The typical GAP envisages monthly deposit of predetermined amount of rupees by the depositors against which physical delivery of gold is given on maturity. Many jewellers in India offer this product and allow the depositor to purchase jewellery from them. This at present provides working capital finance to jewellers but the management of the price risk by the jeweller makes it hazardous at times. GAPs can add a versatile financial instrument to the gold market, besides, the market will get a tremendous boost in terms of liquidity by regular purchases and sales. In order to render GAPs attractive to the small investor, it is essential to keep the minimum investment at a reasonably small amount for each GAP contract. To make the scheme popular, banks could be asked to operate the scheme in their rural branches from where the major part of demand for gold emanates. The GAPs should be liquid so that for very small margins the depositor is able to borrow against these GAPs at low interest rates.
4. ADs could also offer gold loans to jewellers which would provide them necessary working capital as well as act as a hedge against a fall in the price of gold and they could have significant interest savings that are associated with them, given low rate of interest on gold and also less volatile than other interest rates. Banks could be liberal to grant loans against gold bonds/gold linked deposit.

Phase II

In Phase II, it would be natural to expect the financial market to be developed further and the derivative as also the forward market to come into existence.

The forward market in gold is not new to India . In the aftermath of World War I, there existed an active gold and silver market in India -both physical and financial- and gold and silver options and futures were actively traded in the Bombay Bullion Exchange . Banks were involved in this market for providing storage, finance and safeguarding the reputation of the members of the exchange. Mr. Shantilal Sonawala, a former President of the Bombay Bullion Association, remembers that Grindlays Bank and Bank of India used to be quite active and the Zaveri Bazaar branch of Bank of India boasted of a spacious vault. The banks used to be active not only in financing but buying and selling bullion on behalf of their clients. They acted as commission agents. In a thesis for MCom submitted to the Bombay Univer sity in 1954, Mr. Sonawala gives a detailed description of the bullion market where delivery could be either ready or forward, the minimum lot was 250 tolas, good delivery restricted to bars with specified foreign bearings and later markings of the Indian mints as also those of the Bullion Exchange refinery were also accepted. The usual period of the forward contract was one month with an option to the seller, on payment of specified penalty, to carry forward the delivery. Members of the Board of the Exchange and the Marketing Committee constituted the Clearing House Committee which supervised the settlement delivery auction in case of failure to give or take delivery. The exchange functioned smoothly till 1943 . The Bullion Exchange had a four storeyed building with a trading ring and shops for members, spacious vaults and a refinery for melting and assaying of gold. It is gathered that traders from London, China and New York took advantage of the market which played a crucial role in supporting the London market during the silver crisis in 1935. The problems began when disputes started between merchants and the Board and in 1947 the Bombay Forward Contract Control Act was passed and made applicable to the bullion market. The Bullion Exchange Ltd went into voluntary liquidation and the Bombay Bullion Association Ltd was formed in January 1948 and recognised as the only association to deal in futures. The association had 486 members by 1949 and had representatives from government and Reserve Bank of India on its Board. The secular rise in gold prices, shortage of gold stocks and the ban on options led to severe crises in the forward market and with the ban on forward trading in 1962 and with the introduction of gold control, the financial market went into oblivion.

I have dwelt at a little length on the history of the futures market in India only to show that there are well established foundations and practices that could be built upon. As the policy on gold gets liberalised it would be necessary to regulate the gold market and facilitate the development of a smoothly functioning transparent cash and futures market with well laid down procedures for membership, price fixing, settlement, delivery, centralised clearing and settlement in an exchange, code of conduct for members and so on . It would be useful to examine the by-laws of the Bombay Bullion Association Ltd sanctioned by the then Government of Bombay under the Forward Contract Regulation Act 1947 with which the market is familiar and which could be adapted so as to plug any loopholes and suit the present global practices.

The Government had appointed a Committee with Shri Kamal Nayan Kabra as Chairman to examine the feasibility of introducing forward trading in some select commodities, including gold and silver. The Committee submitted its report in September 1994. The Committee has recommended introduction of forward trading in about seventeen commodities including silver but not gold. It is understood to have felt that forward trading in gold may be considered later, after watching for some time the performance of forward trading in silver. It may be noted that Forward Contract Act , which prohibits forward trading and options, will have to be suitably amended if banks have to actively deal in these products.

What should be the ingredients of a well regulated forward or futures market/exchange ?

The ingredients of an efficient futures exchange could be:
- match local needs for bar size and quality
- have standardised contracts (bar size, quality, brands, delivery/settlement dates)
- reliable clearing and settlements systems and efficient warehouse facilities (located in all the major Indian trad ing centres)
- agreements /documents to reduce counter-party and financial settlement risk
- provide cash, futures and options contract
- provide sufficient liquidity on both the buy and sell side
- report turnover and open interest figures daily
- allow both residents and non residents to operate in the market

An efficient and freely tradable exchange in India could attract natural business from South East Asia, Australia, and the Middle East due to its time zone position. It will also bring in participation from the major market centres of Zurich, London and New York. There are tremendous possibilities for Mumbai to develop in a major financial market in gold.

Other Issues linked to development of gold market

Although not directly linked to the development of a financial market there are some other issues related to gold which also need to be examined as they have a relevance to the gold economy and therefore the gold market. These relate to taxation , facilities for refining and ensuring standard quality.

Tax Issues

The present tariff structure for import of gold needs to be rationalised since there is a large variation between the tariff applicable for normal import (72.5%) as against 4 to 5 per cent under the NRI route and 14 to 18 per cent under the SIL scheme (including SIL premium). Such a variation has resulted in a situation where the entire legal trade is undertaken through the NRI route. The rationalisation of the tariff structure should be undertaken based on following parameters:

1. The rate of tariff should be such that there is an incentive to resort to legal imports and not avoid/evade duty.
2. the tariff rate should yield reasonable revenue.
3. The rate should not be so low that India become a conduit for supply to neighbouring countries.
4. The tariff should be such that there is built-in -incentive to use the imported gold for exports.
5. While fixing the rate of tariff, emphasis need not be given on payment in foreign exchange.

As regards sales tax, the present incidence of such tax varies from state to state, which leads to shift in trading activity between states and also is the root cause of many malpractices in the trade and discourages official transactions of trades. There is a need for a uniform sales tax all over the country with separate tax slab on bullion and jewellery. There should be no sales tax for sales through canalising agencies.

The gamut of direct taxes in the form of Income tax, Wealth tax and Gift tax acts as a deterrent to officially declaring the transactions. There is a need to rationalise these taxes if gold banking in India is to develop. The objective of such taxes should be such that along with revenue generation, they should not drive the gold out of the official channel. Gold should be treated as any other financial asset in the matter of wealth and capital gains tax. The anomaly in the capital gains tax which is levied every time there is a sale or an exchange of personal jewellery needs to be looked into.

Melting/Refining/Assaying

At present, gold is mainly refined in Bombay where a few refineries like the India Government Mint and National refinery are active. Some private refineries are also operating elsewhere with limited capacity. As none of the refineries are LBMA recognised there is a need to upgrade and also increase the refining capacity. The standardisation of the refining process at the refineries can be entrusted with the India Government mint. Establishment of new refineries in the private sector with modern technology could be considered for which assistance of reputed foreign refineries could be sought.

Hallmarking of jewellery

Hallmarking is a method by which samples of manufactured jewellery are subjected to a quality check and the approved lots are stamped within the official mark to certify the caratage as assayed. Hallmarking is compulsory in many western countries as well as in South East Asian countries. As our jewellery is not hallmarked, these are subjected to detailed purity checks resulting in delayed realisation of export proceeds. For the domestic market hallmarking will ensure consumer protection. Thus hallmarking of jewellery both domestic and for export should be made mandatory.

Storage and Custody

At present under the scheme of import of gold by canalising agencies the import is required to be utilised through a Customs bonded warehouse for the following purposes viz. supply of gold to manufacturer-exporters of jewellery, sale of gold to holders of SIL, and sale of gold to returning NRIs. In addition to this banks could be allowed to stock and store gold, as it would be less cumbersome than the bonded warehouse system of storage.

I have raised several issues for discussion which I hope would help in initiating a debate on the policy measures that are required in development of a vibrant gold market in India. The country needs to use to its advantage the fact that we are the largest consumer and are favourably placed to develop a vibrant market in gold.