

Address by Dr. Y.V. Reddy Governor, Reserve Bank of India on Gold Banking in India

Gold Banking in India

Mr Chairman and Friends,

I am thankful to the World Gold Council for inviting me to participate in this Conference. It is unusual for the organisers to seek the same speaker and even more unusual for the speaker to accept such an invitation within a span of nine months. That happens in academic circles. It is of course, routine in Toast Masters Club, of which I was a member decades ago. But, this is a gathering of hard headed finance and business people. I presume that the organisers felt that I should be called upon to squarely address the issues that I raised in the last meeting, in a somewhat less inconclusive manner this time. Well, it should be possible to address these issues with a little more confidence now, since the last conference has generated pretty well informed and wide ranging debate on most of the issues posed.

Today, I will briefly recall the issues that I had posed in November last. We could trace policy developments since then. I would also share with you the response we received on the subject, not only from the intellectual circles and media but also through letters addressed to Government and the Reserve Bank of India (RBI) - from people in many walks of life. In this background, and keeping in view the recent developments in economic reform, it is possible to examine the rationale for a New Gold Policy (NGP) at this juncture. The possible objectives and the immediate tasks of a NGP need our attention. If some changes in policy towards NGP are considered necessary, the role of the RBI, banks, government and industry/trade would have to be redefined and reoriented. I will elaborate on the re-orientation. In my normal style, I will conclude with a set of issues. Deliberately, I am avoiding going into details of gold banking since these aspects will be elaborated by Mrs.Usha Thorat, who is one of our resident experts on gold in the RBI.

Issues : A Recall

The issues raised in the last meeting related to demand, supply and use of gold. On the demand side, the need for and the effectiveness of restricting demand were the main concerns. On the supply side, limits to domestic production and the implications of import through various channels were touched upon. The fiscal dimensions, trade policy implications, balance of payments (BOP) impact and the desirability of restricting gold import to corporates or banks were also flagged. The role of the RBI in gold policy, sequencing of changes in such a policy and finally the link with capital account convertibility were flagged for further debate. As you are aware, many of these issues have been debated since then, and there has been policy response also.

Policy Response : A Summary

We have made some progress in liberalising gold policy since we met last. The policy on gold import has been further relaxed and non-resident Indians (NRIs) are allowed to import 10 kgs of gold against 5 kgs allowed previously. The EXIM policy for 1997-2002 has been modified and now in addition to the existing canalising agencies, the RBI will be authorising banks to act as nominated agencies for importing gold into the country under various schemes viz., NRI, SIL and export replenishment/loans, etc. The Tarapore Committee on Capital Account Convertibility has submitted its report and has made wide ranging recommendations relating to gold, including a more liberal import policy for domestic consumption. The RBI has issued guidelines to banks to apply to it for becoming nominated agencies and the first set of applications will be considered

shortly. In the meantime, the customs have also modified the procedures for import of gold - no longer requiring banks to be totally accountable for export obligations of the exporters. The Standing Committee on Gold and Precious Metals in the RBI (Subrahmanyam Committee) has been expanded to include representatives of Ministries of Finance and Commerce. The Committee is more active now in rendering advice to the RBI and the Government.

General Response : A Review

The general response to the issues raised in the previous seminar can be described as one dominated by aggressive liberalisers, some advocating caution, only a few favouring no change in the existing policy and virtually none seeking total roll-back of the policy. There has been no mention of mobilisation of idle gold for productive purposes or establishment of a Gold Bank to raise resources. (i) Let me summarise the arguments of aggressive liberalisers

- a. The gold industry, employing goldsmiths numbering about five lakhs, involving an annual turnover of about Rs.25,000 crore is kept out of any serious consideration, in the current reform process. This reflects continuation of gold control mindset and identification of all import, sale or use of gold with black money. Consequently, gold industry exporters of jewellery and genuine purchasers of gold jewellery continue to suffer.
- b. On account of the present policy, the purchaser of gold jewellery pays a higher price of about Rs.3,000 crore every year because of "hawala" premium, etc. In percentage terms, at wholesale level, it is an extra 17 per cent. Also, because of lack of consumer protection, and improper certification of quality, the purchaser loses about Rs.4,000 crore each year.
- c. The present gold policy shows anti-rural bias. The real purchaser of gold is typically a peasant. Close to seventy per cent of gold jewellery is sold in rural areas and most of gold sales are by way of jewellery. To quote Professor Jeffrey A. Franks, holding gold has in fact often in history served, from France to India, as the only way the peasant can protect himself against inflation and the vicissitudes of politics unquote.
- d. Similarly, there is a gender bias, since most of the jewellery is sought by women. While macho consumer durable components are imported and their production or even consumption financed, a non-depreciating asset like gold is discriminated against. It makes no sense to constrain the demand for "a multi-purpose indestructible asset" like gold or gold jewellery which is a life time asset, a hedge against inflation, a source of liquidity and a preferred form of saving.
- e. From a fiscal point of view, the NRI route generated about Rs.500 crore towards customs in a year. The "officialising" of gold import by liberal import of gold will give Rs.250 crore per annum more towards customs with duties at the same rate as for NRIs. Further, if gold is imported freely under OGL, gold trade down the line becomes traceable and will provide sales tax to State Governments and octroi to local bodies.
- f. From trade policy point of view, the existing restrictions on gold jewellery producing units like EOUs constrain the participants in export market and hampers export growth. Free import under OGL and free export are pre-conditions for capturing world markets - as evident from the Turkish experience.
- g. Some advocate free import of gold or import under OGL on the ground that there may be a fall in reserves and a desirable impact on the exchange rate. However, most argue that there will be only "officialising" of gold import and use of foreign exchange under hawala resulting in no net loss of reserves. In fact, once gold jewellery exports pick up, consequent upon gold-import liberalisation, there will be a positive impact on trade balance.
- h. There is no way of getting rid of or at least drastically reducing the hawala market in foreign exchange, so harmful to social and moral fabric of India, unless gold import is freed and the scope for gold smuggling reduced.
- i. As pointed out by the Committee on Capital Account Convertibility, a pre-condition for further reforms in the external sector is free import of gold.

- j. Finally, while bank credit is available for import, domestic production or processing and easy acquisition or consumption of luxury goods, no such bank credit is available for gold and gold jewellery employing half a million and providing first rate security for banks. In fact, the only way of penetrating the informal credit sector without generating non-performing assets is encouraging flow of bank credit against gold and silver without reference to end-use.

(ii)The cautious liberalisers avoid the subject of liberal bank credit or regulating gold market altogether, but concentrate on possible balance of payments impact. Hence, they advocate limited import through designated agencies to meet both exporters and domestic industry.

(iii)The no changers feel that the existing import regime is foreign exchange neutral; and existing policy is reluctant admission of our incapacity to change the mindset of Indians who are wasting their savings on gold. There is no need to assist or develop this "unproductive" sector or activity.

(iv)There is little support to total roll-back of policy. There was, however, a suggestion in the context of an analysis of the Report on Capital Account Convertibility in the Economic and Political Weekly (EPW, June 1997). This article reiterated the possible impact of liberalisation of gold import on domestic savings in an adverse way; on diversion of productive resources into unproductive channels; on aiding the process of tax-evasion and hoarding of incomes and assets. Having expressed this, the article states and I quote "a more viable policy from the point of healthy and egalitarian development was to recommend the banning of gold imports (other than for jewellery exports and for industrial use), and strict enforcement measures against smuggling" unquote.

Rationale for New Gold Policy Now

Responses to the issues raised by me last year thus show a distinct preference for a NGP. It is possible to highlight the important reasons for a relook at the existing gold policy.

Firstly, it is argued that import or use of gold should be discouraged since it affects domestic savings adversely and implies diversion of resources for unproductive purposes. In reality, our household savings unlike government savings, have been increasing since independence while gold was, inspite of the policy, being imported, traded and used. The diversion of savings to unproductive purposes did not happen in the household sector. Further, the idea of mobilisation of resources for productive purposes as defined by planners has yielded place to a slightly different form of policy management of disposition of resources under the post-reform era. Now, even depreciating luxury goods are produced and traded in our economy. Why discriminate against gold ?

Secondly, it is also held that we should not waste scarce foreign exchange on unproductive purposes. With current account convertibility and market determined exchange rate, it is not appropriate to place a premium on foreign exchange. Further, the recent liberalisation of imports through NRI and SIL route has shown that, in reality, there is no adverse impact of liberalised gold import. In fact, this recent experience should provide reason enough for a review now, with a view to liberalising further. Thirdly, it is felt that gold is an important instrument for black money deals and hence restrictions on gold amount to restrictions on black money. Since gold is not the only instrument of black money deals, making gold-availability difficult will not deter either generation of black money or its disposition in many ways including illegal gold. In any case, with the reduction of income tax rates and the launch of Voluntary Disclosure Scheme in the current year, the fiscal stance is clear - remove incentives for generating black money. Hence, gold policy as an important instrument of anti-black money policy loses its significance, in view of the recent Budget.

Fourthly, international experience especially with Turkey, where conditions are similar, has shown that liberal imports and organised trade in gold benefits the economy including external sector. Also, our neighbours in SAARC region have liberalised and officialised gold imports at nominal duties. These developments make it imperative that we review our policies urgently.

Finally, gold plays an important role in our external trade (next only to oil) and in the domestic economy. The reform process would be incomplete without a review and update of gold policy.

Objectives and Tasks of New Gold Policy

What should be the possible objectives of NGP? The review of our policy so far and the rationale for NGP that we considered indicate clearly the desirable objectives of NGP. The major objectives should perhaps be to:

- a. recognise the importance of gold in the Indian economic system and enable gold to play a transparent and positive role in the industrial development, employment and export sectors of the economy,
- b. ensure orderly development of gold related industry in India in terms of physical standards and consumer protection,
- c. create and nurture appropriate official regulatory framework and self-regulatory trade bodies,
- d. exploit the scope for generating revenues to the central, state and local governments,
- e. align the regulatory framework and institutional capabilities in the financial sector - especially banking sector - to enable the above, including gold banking, and
- f. enable fuller integration of gold with other areas of domestic economy and closer integration with world gold economy, consistent with our economic reform policies.

If we accept the above objectives of NGP, four broad sets of measures may need our attention now. These are (i) gold and trade policy (ii) regulation and development of domestic trading, including quality markup (iii) bank financing for import, export and domestic activities and (iv) gold banking.

First, on gold and trade policy, the broad thrust has to be liberalisation of import and export, but there are many options in this regard, and these need to be debated. First, place gold under OGL. This would be an ideal situation for free trade and freely tradeable good. However, as an immediate measure, some skepticism could be expressed. Gold has some characteristics of currency, a financial asset and has quasi-foreign exchange attributes. However, free import by members of organised bullion market or designated agencies should serve the purpose, with some scope for regulation. Import of gold through designated agencies including banks would help regulate the gold market besides assuring the quality of gold and bringing more transparency in prices. The advantage of restricting import of gold to designated agencies is that the regulators can fix monetary limits on import during the transition. The domestic transactions of gold imported through the designated agencies could be more easily tracked and would be channelised for making jewellery for domestic use or export. This would also boost exports substantially. On this logic, it will be necessary to discourage liberalised import through NRIs. However, it is possible to charge lesser import duty when designated agencies import, to discourage NRI route. In any case, nominal import duty is a pre-condition for liberalised imports. Incidentally, under the liberalised regime, sale of gold by designated agencies has to be freely permitted to domestic jewellery units. Also, the stipulation of payment of duty in foreign exchange may have to be dispensed with in view of the avoidable irritants, the undermining of domestic currency and market determined exchange rate.

Second, impetus to active domestic trading in gold is a logical consequence of NGP. Currently, the industry is fragmented. It will be essential to tackle major operational issues required to give a

fillip to the gold market, such as the development of refining capacity, accreditation of refineries and introduction of the system of hallmarking as a consumer protection and export promotion measure. Further, serial number, fineness and assay mark of the melter and assayer should be found stamped on bars. We may have to allow foreign companies with expertise in this area to set up shop in India. The melters and refiners, both from within and outside India may have to be permitted based on net worth, turnover, etc. Perhaps, we have a lot of catching up to do.

Third, it may be necessary to recognise financing as an important policy component of developing the gold market. As would be explained later, legal and institutional framework is available.

Finally, the development of gold banking will be derived from the policy stance. On this subject, I expect the deliberations in this conference to throw up some ideas.

Role of the Reserve Bank of India

Central banks the world over have a special concern and role in gold economy. The RBI is no exception. Broadly speaking, the role of the RBI spans five areas.

First, and very obvious is the management of gold reserves. Since October 1990, the Bank's gold holdings are valued on the basis of international market prices. We recognise the price risk on the gold holdings and have considered the use of gold options and futures to hedge our risk. However, the RBI Act in its present form does not have enabling provisions. There is also a view that exemption notification by the Government would be required under Section 27 of the Forward Contracts (Regulations) Act to enable the RBI to enter into gold - currency swaps.

Second, the RBI had played an active part in the local bullion market. The RBI had, in the past, close links with Bullion Market Association, and the RBI's nominee was a member. In the seventies, gold sale was organised domestically by the RBI even as it continued its interest in study of gold and precious metals, monitoring prices, trade, etc., and constantly advised Government on policies. The RBI in future under NGP, could play a role similar to Bank of England in the bullion market.

Third, the licensing of import of gold and silver bullion was for a long time a function of the RBI and not of the Import Trade Control. It was only through amendment to the Foreign Exchange Regulation Act, 1973 in 1992 that import of gold/silver and export of gold, jewellery and precious stones ceased to be regulated by the RBI. Now, policy with regard to import and export of gold is under the purview of EXIM policy. However, as per the recent EXIM Policy, the RBI can designate an agency to import gold for selling it to exporters only.

Fourth, in terms of Section 6 of the Banking Regulation Act, 1949, in addition to the business of banking, a banking company may engage in the buying, selling and dealing in bullion and specie. In fact, the Act allows banks to trade in bullion. Banks extend credit against gold. The regulatory role of RBI arises out of its supervisory functions over banks.

Fifth, the RBI has and continues to play its rightful role in influencing the gold policy in the country. We have in fact established a framework for ongoing review of policy in gold. We established a Standing Committee on Gold and other Precious Metals in 1992 which has since been enlarged and activated in 1997. The Committee is also addressing issues relating to the development of gold market and gold based instruments, with providing a significant boost to jewellery export being one of its objectives. We expect this committee to take active interest in matters relating to gold banking also.

Role of Government

I have alluded, earlier today, to the need for an amendment to the RBI Act and also to issuance of notification by the Government under Section 27 of the Forward Contracts (Regulation) Act, 1954. These measures are needed to enable the RBI and banks to enter into derivative contracts in gold. Further, it is not clear whether gold denominated certificates and other gold related products would be deemed to be a security in terms of Securities Contracts (Regulation) Act. There are also wide ranging issues related to taxation. In the European Community, transactions in gold are subject to VAT at rates which vary from country to country. In some countries, gold is subject to sales tax as well. In UK, there is a formal agreement between the Commissioner of Customs and Excise and the London Bullion Market, on matters relating to tax treatment, and no doubt with the support of Bank of England. The Government's role is critical in creating an enabling environment, especially through changes in the legal framework.

Role of Trade and Industry

In the early part of this century, there existed an active gold market in India - both physical and financial - and gold options and futures were actively traded in the Bombay Bullion Exchange.

It is possible to revive this market now. Futures trading is already active in other commodities like pepper, etc. and perhaps there is no reason for disallowing gold to be traded again though under an appropriate regulatory framework. The focus of the regulation could be to ensure that trading is undertaken within prudential limits and correlated to risk taking capacity, to prevent systemic weakness and to induce transparency in trading practices.

We could draw lessons from the British experience. The London Bullion Market Association has the formal responsibility for the supervision of its wholesale bullion market. The Bank of England, with assistance from the London Bullion Market Association, has drawn up a Code of Conduct for the market which covers such matters as confidentiality, market ethics, inducement and conflicts of interest. It is the responsibility of the Association to monitor its members' adherence both in letter and in spirit, and bring any breaches to the central bank's attention. In addition, the Association has taken over the functions previously performed by the London Gold Market and the London Silver Market in connection with the technical aspects of deliverable material, the rules governing application for inclusion in the list of acceptable Melters and Assayers and the codification of market practices as far as clearing and settlement are concerned.

Role of Banks

Currently, the role of commercial banks is limited to investment in gold as an SLR asset and to lend against bullion and specie. As mentioned, banks could play a more active role in financing gold related activities. As an immediate measure, perhaps banks may be (a) permitted to be designated agencies for import, (b) encouraged to lend against gold or silver jewellery as security up to - say Rs.2 lakh without any stipulation on end-use to help peasants and penetrate the informal credit sector, (c) advised to devise gold acquisition plans, (d) permitted to lend liberally to gold jewellery business, and (e) allowed to draw upon international experience to deal in the gold industry.

Issues As you would notice, I have not gone into the details of gold banking - leaving it to my colleague. Similarly, on gold policy and capital account convertibility, my distinguished predecessor, friend, philosopher and guide Dr. Tarapore, Chairman himself will address you later. Deliberately, I have not gone into the issue of current price situation of gold or use of gold as reserves by central banks. I feel that those issues, though of contemporary interest are not directly relevant.

I am thus, left with issues that flow from my presentation today.

First: what should be the possible objectives of NGP? And when should we launch NGP?

Second: is mere liberalisation of import of gold enough of a reform? If not, what are the other measures?

Third: who should be the promoter/regulator for gold trade?

Fourth: what should be the objectives of regulating gold trade?

Fifth: what are the measures that are possible under the existing legal framework? What changes in legal framework are needed to achieve a globally strategic position for India in world gold economy? Sixth: what should be the tax regime, since in many countries the tax regime for gold is somewhat special.

Seventh: how soon could the physical facilities, like quality assaying, marking, designs etc. of international standards be established? What will be the role of foreign investment and technology in this area?

Eighth: how should the banks equip themselves to do gold banking - immediately with the present legal and policy frame - and soon to exploit the opportunities under a possible NGP?

Ninth: and this is critical from the RBI's point of view - what is expected of the RBI in the context of developing gold banking now, and under a possible NGP?

Let me conclude by thanking the audience for patiently listening to me and assuring the Organisers that we in the RBI are eagerly looking forward to the benefit of deliberations here.