Business Standard

Subir Gokarn: All that glitters...

Financial substitutes for gold are key to addressing the pressure from large imports

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A few weeks ago, I wrote a column on guar gum, which got me an invitation to chair a session in a recent seminar on guar organised by the National Commodity and Derivatives Exchange (NCDEX). I learnt a lot, much of which was rather worrying, but more on that in a subsequent column perhaps. This column works the other way. Participation in a round table on gold organised by the Federation of Indian Chambers of Commerce and Industry (Ficci) last week gave me an opportunity to collect and streamline thoughts (some mine, some articulated by other participants) on the issue.

Four broad considerations are going to be significant in shaping a strategic approach to gold.

First, all the handwringing about gold that has gone on over the past couple of years has, of course, been motivated by the enormous surge in the current account deficit, to which gold imports were a significant contributor. The reality is that imports accelerated sharply about five years ago and, while they were certainly a factor, the massive widening of the deficit in 2011-12 and 2012-13 was more the consequence of lower iron ore exports and higher coal imports. From this angle, looking at gold only from the current account perspective is an unduly narrow view.

Yes, reducing gold imports will help reduce the current account deficit, but perhaps only in the short term. For reasons laid out below, a long-term assessment suggests that the demand for gold (or, more precisely, the attributes of gold that Indians set so much store by) will only increase. In the absence of any domestic supplies, this can only be met by imports, unless effective substitutes, which do not involve physical imports, are developed.

In this context, the recent decline in imports, which has helped shrink the trade deficit and thereby the current account deficit, unquestionably provides some welcome relief, but does not reflect any enduring solution. Raising import duties and imposing some quantitative restrictions have, by most accounts, probably channelled gold imports into informal channels without impacting the effective demand for the commodity. A robust solution lies elsewhere.

Second, coming to the fundamental question of why demand may be on an upward trend, there is no reason to believe that the demand for gold is any different from that for virtually all other commodities and products. There is clearly an income effect - the demand for gold will increase as households earn higher disposable incomes and have greater saving capacity. This does not necessarily translate into gold accumulation, because other asset classes can also be chosen, but gold will inevitably figure in the representative portfolio choice, partly for purely financial reasons but also because of inherent preference, which could be attributed to culture and tradition. This brings the demographic transition into play. The current age distribution of the population suggests that the number of gold-intensive life-cycle events, such as marriage, will increase significantly over the next few decades.

Other things remaining the same, imports of gold will only increase. If structural solutions to the other factors underlying the large current account deficit are not found, pressures on the balance of payments will be aggravated.

So, if we take the upward trend as inevitable and immune to the kind of measures that have been taken in the past few months, how should one approach the issue? This leads to the third set of considerations, that is, whether the demand for gold-like qualities in a financial asset can be provided by alternatives, which do not involve physical imports.

Last January, The Reserve Bank of India published a report of the working group chaired by K U B Rao, the groundwork for which was done when I was associated with the institution. Among other things, the group suggested introduction of a number of products that could broadly be labelled "dematerialised". They allow savers to buy gold, but in paper or electronic form. In turn, the issuers of these gold certificates can hedge their exposures on an international exchange, maintaining only a fraction of their total exposures in physical form. Such products assume that a significant proportion of redemptions will be in cash, based on that day's gold price, and not in physical form.

There is, of course, a great deal of scepticism about the attractiveness of such products, based largely on the culture-tradition argument. The fact is, though, that we will never know until they have been tried. Product design could easily leverage off a global template and customise it to Indian requirements. The main challenge is marketing. There has to be a co-ordinated effort by the entire financial system to make people aware of the benefits of this form of gold ownership; there are many from the individual's viewpoint. Perhaps the demographic transition will help here as well. Just as newspaper matrimonial advertisements have been displaced by the internet, perhaps dematerialised gold products will steadily displace the real thing!

An important development from the perspective of gold being perceived as an effective inflation hedge is the introduction of inflation-indexed bonds linked to the consumer price index. Again, effective sensitisation and marketing will be the key to their success, but they should provide an attractive substitute for gold among at least some investors.

The fourth consideration is supply. India currently produces about two tonnes a year, while importing about 1,000 tonnes per year in the past two to three years. However, the big potential supply is in current holdings, which are estimated to be in excess of 20,000 tonnes. Bringing even a fraction of these holdings into circulation will have an enormous impact on the supply situation. An appropriately regulated gold loan market will contribute to this process, but unlocking large holdings will unquestionably require an amnesty of some kind. Of course, this decision has to be made as part of a wider approach to revealing concealed income, with all the attendant concerns about moral hazard and the incentives for further concealment in anticipation of another amnesty in the future.

There are, of course, a number of other issues, which space does not allow me to address here. The bottom line is that the four considerations - the current account deficit, demand, alternatives and supply - provide a reasonable platform on which to think about the objectives and instruments of strategy. The test of success is that all that glitters shouldn't be gold.

The writer is director of research, Brookings India, and former deputy governor of the Reserve Bank of India. Views are personal