India’s Gold Rush

C.P. Chandrasekhar

India’s obsession with gold is posing a challenge to the government’s neoliberal agenda. Excepting for a period when a small share of India’s incremental gold consumption was met by the Kolar gold mine, India has been almost wholly dependent on gold imports to satisfy domestic demand. With, foreign exchange scarce and needed to purchase essential capital, intermediate and consumption goods, it was not surprising that the government chose after Independence to severely restrict gold imports and limit access to the yellow metal. This was also seen as necessary to prevent the diversion of the savings of the well to do away from productive investment into a materially unproductive asset like gold. Though the initial near total ban was subsequently relaxed, controls remained in place and were enshrined in law by the Gold Control Act of 1968. While the smuggling of gold did keep gold inflows into the country at significant levels, they were in all probability much lower than what would have entered if the controls were not in place.

The decision to in the early 1990s to dispense with the Gold Control Act was seen as symbolising the boldness and breadth of trade reform. This did open the floodgates to the inflow of gold desired by the Indian rich and the middle classes. According to economist A. Vaidyanathan, quoting estimates for an earlier period that are not official and cannot claim to be robust, gold imports into India amounted to 13 per cent of merchandise exports and about 8 per cent of merchandise imports in 1970. By 1997, when India’s overall trade dependence had increased, gold imports were the equivalent of 20 per cent of merchandise exports and 16 per cent of total merchandise imports. Liberalisation did seem to have unleashed the pent-up demand of a section of Indians who had the desire and the wherewithal to invest in large quantities of gold, but whose demand had been restrained by a policy that believed that they should not be given the freedom to use the nation’s scarce foreign exchange to satisfy their whim.

But this was just the beginning. According to recent official estimates, gold imports, which are now substantially legal, have risen from $3.8 billion in 2002-03 to $10.5 billion in 2004-05, $28.6 billion in 2009-10 and an estimated $57.5 billion in 2011-12. The trend seems unrelenting with early estimates suggesting that India imported $39.5 billion worth of gold during April-December 2012. In fact, triggered by the expectation that government is about to hike the import duty on gold, market estimates suggest that traders imported 30 metric tonnes in the week ending January 11, as compared with normal imports of 5-6 metric tonnes a week.

The result of the surge is that gold has begun to weigh heavy on India’s balance of payments. Though aggregate merchandise imports have risen sharply in recent years, gold imports in 2011-12 accounted for more than 11 per cent of the country’s aggregate merchandise imports, and amounted to the equivalent of 30 per cent of its trade deficit and around three quarters of its current account deficit. Thus, partly as a result of these imports, the current account deficit, which used to be considered high even when at around 3 per cent of GDP, had risen from 4 per cent of GDP to 4.6 per cent between the first halves of 2011-12 and 2012-13, and stood at an ominous 5.4 per cent in the second quarter.

This is forcing the government to rethink its gold import policy. Expressing concern at the sharp rise in the current account deficit on India's balance of payments, Finance Minister P. Chidambaram, suggested that the government would have to introduce measures to render gold imports more expensive since imports of the metal are a major contributor to the deficit and therefore are a strain on the balance of payments.

What is still unclear is the reason for the post 2002 surge in gold imports, which coincides with the years of high GDP growth, but reflects a much faster pace of expansion in the demand for the metal. From the point of view of the "customer", the passion for the metal is explained by many factors. There is the traditional obsession with the yellow metal as an adornment and an item of personal display. In this incarnation as a consumer durable, demand for it is seen as driven by a peculiarly Indian taste and by its role as a symbol of status. It has also been seen as an important investment, being a store of value that benefits from price appreciation, which is normally higher than the increase in the general price level and makes the commodity a good hedge against inflation. Gold is also characterised by a high degree of liquidity (in the sense that it can be converted easily into cash of equivalent value), since it could either be sold or pawned without much difficulty. In recent years, the proliferation of 'loans against gold' schemes offered by banks and non-bank financial companies has made the metal even more liquid. Thus, from a private perspective it is a highly prized possession. It is also the asset to which wealth holders shift in search of safety, when inflation is high or times are uncertain. In fact, for long gold (like land) was seen as a preferred asset of the rural rich, who were considered ill-informed of alternative financial assets that capitalist development was delivering. Therefore, demand for gold as an asset was considered as more linked to the incomes of the rural rather than urban surplus earners. But all that has changed. The rich in general want hoards of gold in their asset portfolio.

At present, much of the metal acquired is being used to build a hoard. This aspect of gold purchase is often underplayed. Despite India's role as an exporter of gems and jewellery, gold re-exports have been way below imports and net imports of gold have been extremely high and rising. The lobbyist for the world's gold industry, the World Gold Council, argues that gold jewellery accounted for around 75 per cent of total Indian gold demand in 2009 (with only around 23 per cent being acquired as investment and 2 per cent for decorative and industrial use). However, drawing a line between the purchase of gold as consumption good and its purchase as a hoard is near impossible. And the magnitudes involved make sense only when the commodity is seen as a hoard held for speculative purposes.

Moreover, whether acquired as consumption good or investment, the obsession with gold is detrimental to development. This is a classic case of the divergence of private gain and social benefit. When the private demand for gold rises, since the commodity is not produced domestically it has to be imported by using up the country's export earnings, with adverse social effects. The private purchase and hoarding of gold results in the diversion of surplus away from productive investment that a developing country can ill afford. With India being the world's largest importer whose demand is rapidly rising at a time when global gold supply has been more or less stagnant, the price of the metal has risen sharply, increasing the foreign exchange outgo on account of gold imports. Domestically, gold price increases seem to be no major corrective to the rising demand, even though domestic prices are rising even faster than global prices. Rather the price increase has substantially increased the speculative demand for gold as an asset, since returns on gold are seen as higher than that obtained in equity and even real estate markets. The process feeds on itself generating a speculative spiral, with the rich playing in the casino to the detriment of the nation.

It is in this background that an unstoppable liberaliser like the Finance Minister has underlined the need to rein in imports, possibly by raising the import duty from 4 to 6 per cent. The other option, recommended by a working group of the Reserve Bank of India (RBI), is to administratively limit gold imports by "setting value or quantum limits for canalising agencies and banks", which are the immediate importers. The response has been immediate and aggressive. The trade, which has been raking in profits riding on the gold rush, has as expected responded adversely, with horror stories of the huge unemployment and large scale smuggling that would result if gold imports are sought to be curbed.

The fact is that a duty hike is an inadequate response to deal with the problem for a host of other reasons. On the other hand, the government is fighting shy of imposing quantitative restrictions. The report from the RBI's working group, which has been released for comments, points to the soft touch the government seems committed to. The report argues that imports cannot be curbed beyond a point, either with tariffs or quantitative restrictions, since that would only encourage smuggling. So the search is for ways to satisfy the appetite for gold without having to import a good that is not produced in the country. One method suggested is the formulation of a gold deposit scheme in which deposits of gold from current owners is used to meet demand from new buyers, with the guarantee that the deposit would be returned to the owner at maturity. It is not clear how this would work over time, what risks are involved, and who would bear the risks. Another suggestion emphasises the fact that gold demand is driven by its role as an asset that offers a good return, is a hedge against inflation and is liquid. So the need, it is argued, is for alternative assets that replicate these features. If they existed the market, it should be presumed, would have by now discovered them.

The evidence is clear that soft solutions like these will not work. According to estimates from the World Gold Council, over the year ended September 2011, demand for gold in India was 1059 tonnes, as compared with 214 tonnes in the US and 770 tonnes in China, whereas per capita income in the three countries stood at $1,410, $4,940 and $48,620 respectively. The "average" Indian could not be responsible for such "excess demand" for gold. So the rich have to be reined in since they are putting the nation at risk. A return to gold control of a workable kind is imperative.

* This article was originally published in the Frontline, Volume 30: Issue 2; Jan. 26-Feb. 08, 2013.