

A Study on Investment in Gold and Its Impact on Indian Economy

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Abstract

India has been known to possess large stocks of gold and studies show that they are mostly accumulations from centuries of trading rather than result of production of her mines. What is of contemporary interest, however, relate to the demand, supply and price movements and their link with policy. Some broad generalizations on these aspects would be appropriate to review the policy and identify the issues. India imports most of its gold requirement. Gold as a commodity on its own does not add much to the productive capacity of the economy. Moreover, the foreign exchange reserve that is used to import gold reduces the availability of this resource to finance the import of other commodities. Such high value of gold imports has now started hurting India's current account position. This paper studies the reasons and significance of investment in gold in India and its impact on imports of gold, CAD and Forex reserves.

Key Words: Gold, Economy, India, Investments, Imports.

Introduction

Gold has long been considered one of the most precious metals and its value has been used as the standard for many currencies (known as the gold standard) in history. Gold has been used as a symbol of purity, value, royalty and particularly associated with the roles that combine these properties. It is also used in international transactions. Gold consumption observed a sharp acceleration during the 1990s amidst liberalization of gold import policy, strong economic growth and favourable movements in gold prices. For centuries, civilizations have used gold as an object of luxury. Gold is taken as a sign of power and status. Gold holds great sacred meaning in Indian culture, as it is the symbol of the Hindu goddess Lakshmi, considered highly auspicious.

Hindus believe that gold will bring them good fortune and destiny. India is a vast country, a combination of several cultures, traditions, customs, religion and regions but the love for gold is universal. It is equally sought by rich businessman or a poor farmer. The Indian tradition demands buying gold for occasions such as weddings, birthdays, anniversaries and other important festivals. The Hindu calendar also has some auspicious days to buy gold such as Diwali, Dussera, Dhanteras and Akshay Tritiya etc.

It is a given fact that over the last decade, gold has given returns which no other asset class has been able to match. However, the demand for gold among Indians has always been price independent. Gold is a traditional investment strategy Indians follow. The effect of high prices has been minimal on the volume of gold imported. The lower prices may increase the demand in the coming days. It is the economies of the US and Europe that play a major role in determining the price movements of gold. By importing gold for our consumption, we Indians are investing in the international markets and helping their economies.

Over the last few years, the Indian markets are supported majorly by the foreign inflows. Participation of Indian domestic investors becomes all the more important for the Indian markets to prosper. Even for the transition of India from a developing market to developed market, it is important that the domestic investors stay invested in the capital markets.

Significance of Gold in Indian Culture

- ❖ Gold is considered as equivalent to liquid cash

- ❖ Gold is a very good form of investment
- ❖ Gold is accepted as a prestigious gift item
- ❖ Gold is considered as a status symbol
- ❖ Gold has a religious significance
- ❖ Gold has great ornamental value
- ❖ “Gold”: A great desire to inherit as ancestral property

Gold Rush on Indian Economy

“An inch of time is an inch of gold, but one can't buy that inch of time with an inch of gold”. This Chinese proverb applies perfectly in the case of Indians who invest in gold as a security for bad times in the future. It is this craze for the yellow metal which is ruining the Indian economy. There is a heavy impact on the Indian economy because of the gold consumption by individuals in India. The common man understands that he makes an investment in gold by paying in terms of Rupees, the Indian currency. But the actual fact is that the payment for their investment is made in terms of dollars. By purchasing billions of dollars' worth of gold, they are actually sending out Indian cash overseas, disrupting the balance between the money that is entering and leaving the economy.

This imbalance finally drives down the value of the Indian rupee. As a result of the devaluation of the Indian currency imports become more costly and the businessmen find it difficult to pay off their international loans. If gold imports can be restricted for one year the current account deficit scenario of India can be completely changed. India is the world's biggest gold importer soaking up a third of the world's supply of gold every year. It is this import of gold which is curbing the growth of Indian economy.

Review of Related Literature

Dr. S. Amrita Rai (2009) studies the financial crisis that rocked the global markets by the end of 2008. Due to this crisis a new trend of investing certain amount of their portfolios in gold began and the regular investor started investing in gold. Gold no doubt is a hedge against all kinds of uncertainties but the Governments need to take strict measures to control the increasing prices of the yellow metal and help the investors overcome the losses due to uncertainties in the other markets. Fan Fei (2010) explains in his paper about the attempt to disentangle the price movement of gold after the Bretton-Woods system, the last international monetary regime based on gold. The author concludes that in the recent years there is an increasing trend in gold prices and in the years to come there is going to be an aggressive growth in gold prices. Mishra and Mohan (2012) opine that domestic and international gold prices are closely interlinked. And then their study examines the nature of the changes in the factors affecting international gold prices during the last two decades.

Short-run volatility in international gold prices used to be due to fluctuations in traditional factors such as international commodity prices, US dollar exchange rate and equity prices. Raturaj et.al 2012 in his research paper makes an attempt to analyse the causality relation that may run between domestic gold prices and stock market returns in India. The study is carried out by taking into consideration the domestic gold prices and stock market returns based on BSE 100 index. The author investigates using the Granger causality in the Vector Error Correction Model for the period January 1991 to December 2009. The analysis provided the evidence of causality between the variables.

Objective of the Study

- To analyse the impact of gold investment on imports of gold
- To analyse the impact of gold investment on CAD
- To analyse the impact of gold on forex

Research Methodology

This paper aims at investigating the factors for steep rise in the prices of gold in India. This study is majorly

based on secondary data that have been collected from the database on Indian economy which is maintained by Reserve Bank of India. The study analyses the yearly domestic gold prices which have been calculated by taking average of gold price of every month in a year.

Data Analysis

The highest share of Indian imports is petrol and crude oil (30.1%) and the second position is gold and silver (10.1%). (See Table 1). The third position is taken by pearls and precious metals, which are again supplementing the gold imports. The oil import is huge burden on India's BOP but oil consumption is something which is very difficult for India to reduce but there is an option to restrict and control the imports of gold and silver.

It is in fact shocking to note that India dominated over China in its demand for gold. (See Table 2). It is very clear that India is the world's biggest importer of gold. It accounts for nearly one third of the total world's demand for gold. Indian consumers' demand for gold is 37.6% more than that of China, another major economy of the world. Russia, USA and UK do not even come close to the levels of Indian and Chinese consumer demand..

Impact of Gold Imports on CAD

The nation's CAD, which reached a record 6.7 per cent of GDP in three months ended in December 2013, is widely considered the biggest concern for Asia's second largest economy. CAD represents the difference between India's imports of goods and services and its exports plus remittances by Indians living abroad. One way of looking at it is that India does not earn enough in foreign exchange to pay for imports such as oil and fertilizers. The excess of imports over exports, or the CAD, is usually covered by foreign investors bringing money into India or by dipping into the country's forex reserves. According to the Reserve Bank of India, with domestic production of gold falling to an insignificant level, current gold consumption is met entirely through imports. Though it is generally considered that a CAD of between 2.5 per cent and 3 per cent is sustainable for India, it has been very high since 2011, and external resilience has weakened on account of gold.

Impact of Investment on Gold on Forex Market

The first major problem faced by the Indian economy is a high rate of gold consumption which is resulting in increasing CAD. India has to pay for its gold imports using its foreign exchange reserves. In spite of India being the largest importer of gold in the world its share in the total reserve of the country is the lowest. India is leading in terms of gold demand, however it lags behind in maintaining good foreign exchange reserves. India is in the sixth position with as low as 9% gold in the total forex reserves as can be seen in Table 3.

Gold Locked in Temples

The potentially large but a dormant source is the gold locked up with the temples across India. Larger holdings of gold are estimated to be with Balaji temple, Tirupati in Andhra Pradesh, Sree Anantha Padmanabhaswamy temple, Trivandrum, Guruvayur temple and Sabarimala temples in Kerala, as well as scores of religious places in southern states, with substantial gold holdings. The Sree Anantha Padmanabhaswamy temple is estimated to have gold holdings valued at more than Rs. 1000 billion. According to Jamal Mecklai, chief executive, Mecklai financial, the Tirupati temple could have gold holdings of almost 1700 tons. Even if the government borrows 500 tons from Tirupati and pays it two percent interest, the temple authority could earn 30 billion a year in interest. Tirupati's holdings could be about five percent of an estimated 30,000-35,000 tons of gold held in India.

Action Taken by the Central Government

The government has tried to tackle the problem, raising import taxes and considering changing regulations so that less gold comes into India via the banking system. But the recent drop in gold prices could have provided the most effective fix. In August 2013, the finance ministry had banned banks from selling gold coins in order to contain the country's burgeoning CAD. Gold imports have fallen sharply to \$650 million in August 2013 on account of the steps taken by government to curb inbound shipments of the precious metal. Gold imports are estimated to have declined by 41 per cent to 500 tons in 2012-13 financial year on account of curbs imposed by the government.

Action Taken by the RBI

The Reserve Bank of India (RBI) thinks that a CAD of 2.5 per cent of the gross domestic product (GDP) is sustainable. Against this, India's CAD in 2011-12 was 4.2 per cent of GDP and in the last quarter for which data is available, was 6.7 per cent of GDP. The greater the gap between the sustainable CAD level and the actual figure, the more vulnerable the economy is to adverse global developments which could suck out foreign investment. On the quantitative front, RBI introduced the 80:20 formula under which 80 per cent of imports would be for domestic demand while 20 per cent of total imports would have to be re-exported through value additions in the form of jewellery.

Alternatives to Reduce Investment in Gold

- **Increase the reach of Banks:** The growing demand for gold purchases in the country is an indication that households with high levels of savings are looking at options available to invest their savings. As per a World Gold Council Report, India has one of the highest saving rates in the world; estimated at around 30% of total income, of which 10% is invested in gold. Therefore it is important that the financial sector taps this huge saving reserve. This is particularly true for the rural areas where according to the same World Gold Council Report only 21% of rural India had access to formal financial sources. Therefore lack of availability of alternate avenues of investment that might be resulting in heavy gold purchases.
- **Innovative means of alternate investments must be considered:** It must be understood that it is easier for a rural person to buy gold jewellery than opening a deposit account in a bank, due to various documentary formalities that are required. In the competitive environment, banks have to contend with the transaction cost associated with servicing retail deposits and credit accounts.
- **Liquidity quotient of alternate investment instruments:** A prime reason behind increased gold purchase is its liquidity aspect that is, in case an individual requires money he can immediately sell his gold for cash. This is usually not the case with other financial products as redeeming them usually takes time. Information technology could play an important role in facilitating retail banking in rural areas. However, the government can also consider introducing high liquidity across the counter instruments with the government guaranteeing buybacks.
- **Massive education campaign must be launched:** Another alternative is to create awareness amongst the public at large as to how unnecessary piling of gold stocks with households is not only adversely impacting the current account position of the economy but is also increasing the level of black money circulation in the economy. This is happening because the purchase and sale of gold is being done in cash thereby hurting the government on two fronts. Firstly, purchasing gold against cash gives an individual an opportunity to convert his black money into white. Secondly, the cash received by the seller also remains undeclared and thereby no tax will be paid. On top of this the gold imports are being financed by the hard earned foreign exchange. Therefore it is imperative for the government to educate the citizens of the country about the adverse impact of rising gold imports.

Conclusion

India's passion for gold is not new. However, what has happened over the last few years is that rising gold imports have coincided with a rise in its prices and a weakening of the rupee against the dollar. The combined impact has served to extend the CAD. As Amartya Sen, a noted economist, has acknowledged "the importance of a holistic growth and advocated the thought that human development, as an approach needs to be the basic development idea thereby suggesting that it is advancing the richness of human life, rather than the richness of the economy in which human beings live."

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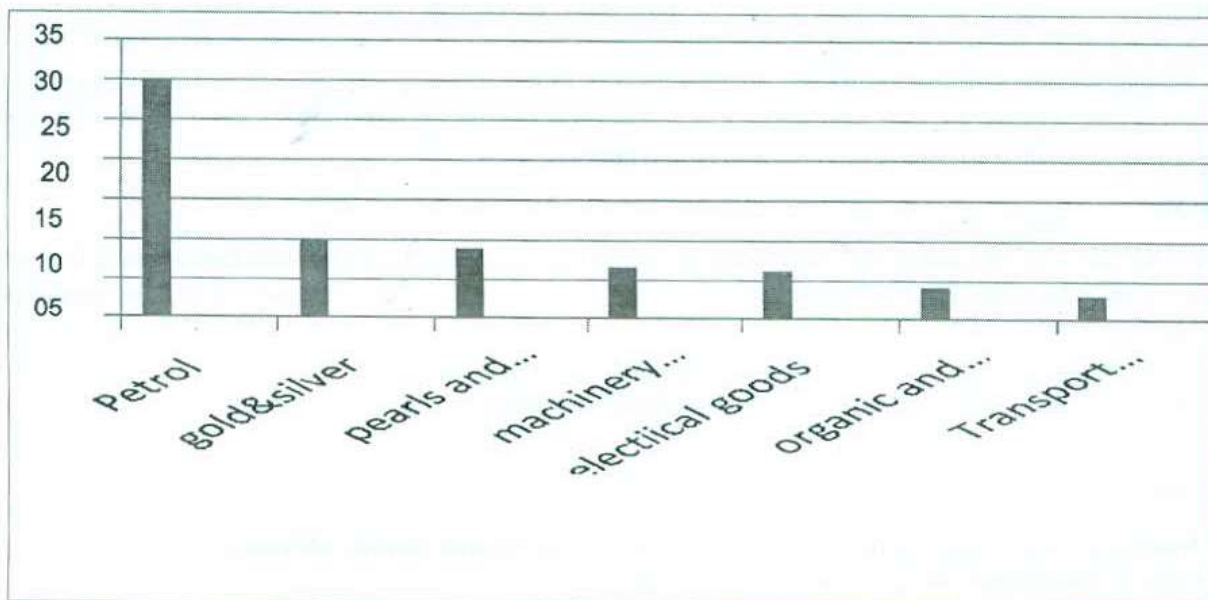
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Table 1: Top seven commodities imported by India and the percentage share of imports for the year 2013

Commodity	Percentage of share of imports
Petrol crude and product	30.1
Gold and Silver	10.1
Pearls, Precious and Semi-precious Stones	8.9
Machinery except Electrical and Electronics	6.6
Electrical goods	6.1
Organic and Inorganic Chemicals	4.2
Transport Equipment	3.1



Source: www.rbi.org.in)

Table 2: Consumers gold demand for consumption in tons

Countries	Jewellers(Tons)	Barsand Coins (Tons)	Total(Tons)
India	649.9	409.1	1059
China	508.9	260.8	769.7
Russia	70	—	70
USA	119.3	94.2	213.5
UK	25.2	—	25.2

(Source: www.rbi.org.in)

Table 3: List of countries and the percentage of gold in total reserves

Countries	Gold as % ofTotal Reserve
USA	77
Germany	74
Italy	73
France	72
Netherlands	62
India	9