

## **Sovereign Gold Bond: Global Experience and Suggestions for India**

### Context:

India is the largest consumer of gold in the world accounting for around one-fourth of the total consumption. Gold has always been an integral part of the socio-economic ethos of the Indian households. Gold has been traditionally considered as a store of value or hedge against inflation. It has always carried sense of cultural and sentimental attachment, making its consumption and investment in India very different from that of other countries.

Over the past five years alone, consumers in India have bought almost 4,500 tonnes of gold and demand is forecast to remain buoyant for many years to come. An estimated 22,000 tonnes of gold are currently held in Indian households, worth more than \$1 trillion.

Gold, lying with consumers, is viewed as an idle asset and a key factor behind the current account deficit (CAD). Famous economist Lord John Maynard Keynes commented that India's gold consumption reflects the 'ruinous love of a barbaric relic'.

Over the past five years, annual demand averaged 895 tonnes, equivalent to 26 per cent of total physical demand worldwide. This gold is largely imported. Along with oil, gold imports had contributed to high trade imbalance. This had prompted Government of India (GoI) to take several measures to dampen demand for imported gold.

These *inter alia* included: (i) increase in customs duty on gold imports, (ii) prohibition of import of gold in the form of coins and medallions, and (iii) direction to all nominated banks and other entities to ensure that at least 20 per cent of every lot of gold import was exclusively made available for exports. Policy-makers, however, have had very limited success in moderating the gold imports.

Despite government restrictions, demand for gold remains strong and enduring, whatever is the macro-economic, fiscal or political circumstances. Therefore, demand for gold has remained inelastic. One plausible strategy to moderate demand for gold is to provide a safe and similar alternative. Data shows that every year, Indian investors buy around 350 tonnes of gold in the form

of coins and bars. These investments can be channelized into financial instrument, which would mimic the characteristics of gold. Sovereign gold bond is one such asset. Honourable Finance Minister in his budget speech for the Union Budget 2015-16 announced a scheme to introduce a Sovereign Gold Bond.

#### Is there demand for a sovereign gold bond?

One of the enduring presumptions relating to gold consumption in India is the attachment of consumers to physical gold. It was always felt that financial products relating to gold will see little demand. In this context, a survey commissioned by the World Gold Council and conducted by the Federation of Indian Chambers of Commerce and Industry (FICCI) merits attention. This Survey found that Indian consumers are prepared to use interest-bearing gold-savings products, if the conditions were conducive. The survey states that more than 60 per cent of respondents responded positively.

#### Sovereign Gold Bond for India:

The Finance Ministry has started the product development process in earnest and a draft proposal on Sovereign Gold Bond is placed in public domain for public consultation.

The broad features of this Sovereign Gold Bond Scheme are:

- issuance by RBI on behalf of the Government of India;
- tenor of the bond at 5 to 7 years nominal rate of interest say indicative lower limit of 2% (linked to international rate for gold borrowing);
- sale to resident Indians only;
- quantitative restriction of 500 grams per person per year;
- collection and redemption through Banks/NBFCs/Post Offices
- bond to be a part of the sovereign borrowing;
- bonds to be used as collateral for loans;
- easy tradability on exchanges;
- KYC norms; capital gains etc. are similar to investments in physical gold.

The product could be attractive to investors as it obviates the costs and risks associated with physical storage of gold and pays a nominal interest on the investment. For the issuer, it would serve the public policy goal of moderating gold demand and its beneficial impact on CAD.

### Global Experience:

Globally, there may not be many parallels for a sovereign gold bond as no country faced the kind of gold demand India is experiencing. But, we have a recent instance wherein a commercial bank in South Africa has issued a gold bond. First Rand Bank has issued a gold bond backed by Krugerrands. These bonds earn 0.5% interest payable in gold and have a tenor of five years. On maturity, investors can either claim gold or accept cash. The bonds are listed on Johannesburg Stock Exchange and enjoy good liquidity. The bonds provide direct exposure to the rand gold price and a positive yield in the form of interest ounces payable on maturity. It offers both inflation and rand/dollar exchange rate protection while avoiding the significant storage and administration costs associated with direct gold investment. In many ways the First Rand Gold Bond is akin to the sovereign gold bond planned in India.

### Product Design is the key:

Given the unique attributes of gold in Indian milieu, design of the sovereign gold bond must be carefully done if the desired policy outcomes have to be achieved. The following issues merit attention:

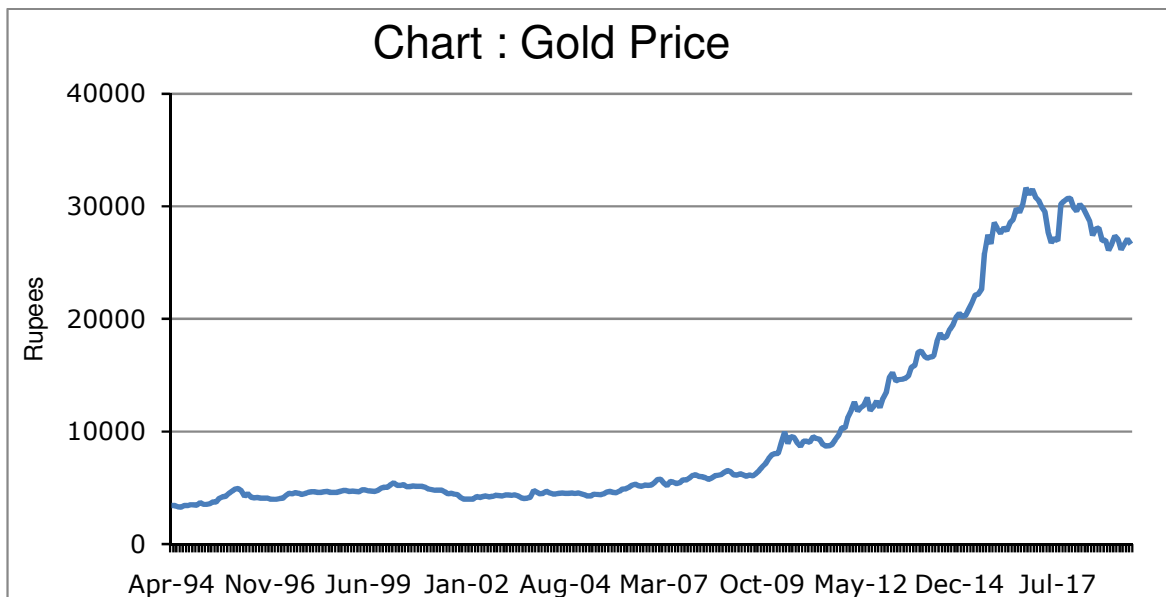
- The financial product must provide correct incentives to the investors to postpone their investments in physical gold.
- The interest rate needs to be set so that the investors earn a decent real rate and the interest rates need to be in alignment with monetary policy objectives.
- The distribution channels must be varied and wide spread to ensure effective distribution.
- The liquidity needs to be ensured: trading on stock / commodity exchanges need to be enabled and the bond must be accepted as collateral.
- Banks may structure loan products with the bond as collateral. In States such as Andhra Pradesh, agricultural gold loans have been extremely popular. In times of crop failures or agrarian distress, gold loans were taken to tide over the crisis. If such facilities are offered sovereign gold bond, the demand would be positively impacted.

### Some Issues relevant to Indian version of gold bond:

- The gold price has remained highly volatile in recent years as the coefficient of variation was 16.0 per cent during April 2010 to March 2015. As a result, GoI will be running a price risk on the amount of bonds issued due to international gold price movements. For example,

between April 2010 and March 2015, gold price has gone up by about 57 per cent with a compound annual growth rate of around 9.5 per cent. Hedging of this risk is expensive and GOI has decided that the risk would not be hedged. However, there will be an impact on the budget if the risk materialises by offering of high real interest, the scheme may become very popular but could cause fiscal drain. To keep the risks at low level, proposed issuance is capped at Rs. 12,500 crore [around 50 tonnes in the first year]. The cost to GoI for issuance for selling bonds equivalent amount of 50 tonnes of gold in the first year would be around Rs. 12,500 crore at the current gold price of Rs. 2,500 per gram and at the interest rate of 3 per cent per gram. If the gold price increases by 20 per cent, in the next five years, GoI may incur additional cost of around Rs. 2,500 crore at the time of redemption.

- The target of 50 tons appears modest and forms just 3.8 % of last fiscal year's imports of 1,332 tonnes. This would barely make a dent in the overall demand. The initial issuance of Rs. 12,500 crore will have little impact on public debt. However, if further issuances are contemplated, it could serve GoI well if a sinking fund type structure is planned to hedge risks.



- On the other hand, it is expected that that international gold price might fall due to strengthening of US Dollar in response to expected increase in interest rates by the US Fed. The gold price in rupee terms has declined by around 10 per cent since last year. Therefore, the investor response might be tepid for fear of capital loss. While purchase of underlying

gold is subject to the same risk, the fact that the loss is not realized in monetary terms due to the buy and hold behaviour of the average investor may still encourages them to buy physical gold.

- Success of the bond is also dependent on the distribution channels. As the bond is targeted at retail investors, it would serve GOI to distribute it widely. The draft scheme envisages distribution through Banks/NBFCs/Post Offices. We can also look at agents to popularize these bonds as they have demonstrated in erstwhile small saving schemes.
- The initial public feedback to the draft scheme is positive. Many have expressed view that Sovereign Gold Bond Scheme is a welcome initiative to help divert physical gold savings to paper gold and/ or postpone the purchase of physical gold jewellery, thereby giving a long term direction to the Indian gold sector as well as help reduce India's overdependence on gold imports. There are demands for setting higher interest rate and clamour for tax concessions.
- There are concerns relating to fixing interest rate and its implications for monetary policy. If the floor on gold bonds is 2%, it is akin to putting a 2% real floor on savings rates. This would impact monetary policy transmission. A market determined interest rate in line with the present macro-economic fundamentals and linked to international rate for gold borrowing would be appropriate rather than having an interest rate floor.
- The government should be cognizant of the potential risks to the fiscal position upfront and monitor them on regular basis.
- The draft envisages investments in these bonds being made by entities, which gives an impression that companies / trusts etc. too would be eligible. It is to be seen whether these entities should be given opportunities to invest in the product and whether GOI needs to take price risk for such investments.
- Another important issue is timing of issuance of Sovereign Gold Bond scheme. At the current juncture, where the international gold price is falling sharply due to expectation of strengthening of the US dollar, news of near term policy rate hikes by leading central banks viz., the US Fed and Bank of England, and easing of geopolitical tensions in the Easter Europe and the Middle East. Between end-March and end-July 2015, gold price in rupee terms has fallen around 6 per cent. Therefore, from a seller point of view, the demand for the bond may not be robust.

- A stronger dollar is accompanied with high growth or a pick-up in the US economy and strong equity and bond markets could dampen demand for gold. These are the conditions that are presently leading to lacklustre investment demand in gold. Combine this with an improved demand globally for risk assets such as equity, and gold is getting overshadowed. Global demand from exchange-traded funds (ETFs), which had shot up till about three years ago, has reduced. As a result of these factors, price has corrected around 40% from its peak of \$1,900 in August 2011. But some interest has returned at these levels; World Gold Council data shows that after seven quarters of being sellers, globally ETFs reported net purchases for the first quarter of 2015.
- The recent fall in price has come after a 12-year rally. Also, macroeconomic conditions globally are not supportive of any near-term rally in prices, and an interest rate hike by the US Federal Reserve can dampen sentiment and gold prices further. Therefore, even if prices don't fall much in the near term, a rally, too, is not likely soon. An investor must keep in mind that gold is only a store of value. Though it is a hedge against inflation, price gain is subject to global factors. At present, most of these factors are negative for gold.
- The decline in inflation and RBI's commitment to fight inflation and maintain positive interest rates are welcome developments that will impact demand for gold. With Reserve Bank targeting CPI and moving to a monetary policy framework that clearly articulates medium term inflation target, inflation is expected to remain benign. As inflation is likely to be low for and impact of international factors is evident, on gold prices; demand may be an issue.
- However, Gold's performance over the years has been stellar: during last five years, i.e., between July 2010 and June 2015, the gold price in rupee terms has increased by 1.5 times. During last 10 years, gold price has increased by around 4.5 times, and increased by around 6 times during last 20 years. If one observes these trends, investors will find investment in 5-7 year gold bond reasonably attractive.
- The government should guard against the tendency to insure the bond holder against capital loss to augment demand for the product in view of falling gold prices. The bond needs to be firmly anchored to the gold prices. Any protection against capital loss would encourage perverse incentives and speculation on gold prices.

### Way Forward...

The draft scheme appears to be a step in the right direction, albeit a small one. The target of fifty tons may not be very large but the response to the scheme would determine future contours. There is positive buzz from investors which is welcome. There are certain design issues that need to be ironed out viz. setting of interest rate, ensuring wide distribution etc. It is generally felt that the measures taken to monetise gold are unlikely to have significant impact on gold demand in short-term. Longer-term effect on gold imports and is dependent on the success of the scheme. It would be interesting to watch future events in this regard.