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Tying investors into gold bonds can help slash the CAD

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In recent years, India has consistently been the world's biggest importer of gold. In 2012, we bought 863 tonnes of gold, accounting for 28 per cent of global purchases. Over the years, we have accumulated 20,000-25,000 tonnes of gold, with a staggering market value of over $1 trillion, even as domestic output is a trickle.

Our appetite for gold is now faulted for endangering our macroeconomic stability, being a major contributor to the current account deficit. India's current account deficit was roughly about $80 billion in 2012-13. Since gold imports alone amounted to about $60 billion, a short-to medium-term solution is to reduce demand for imported gold. The Indian government is engaged in the same quest but the methods used — periodically hiking import duties and putting in place sundry restrictions — have had unwelcome consequences.

In a throwback to the pre-liberalisation era, we are once again seeing a surge in gold smuggling. The jewellery industry employs about 35 lakh artisans and their livelihoods are at risk. If only India could mobilise 300-400 tonnes of gold from the public every year to meet its domestic demand, we'd be on our way to controlling current account deficit.

But how do we do this?

The Indian psyche looks at gold as investment for the long term rather than as consumption. Perish the thought, therefore, of buying gold from the public. Rather, let's think about leasing gold from the public, say, through issue of a gold bond that delivers back to the investor the same amount of gold as was taken from him.

Banks in India currently offer gold deposit schemes that do the same, but they have failed to take off for two reasons: the lack of a retail push and low returns to investors.

The Gold Collection

The retail focus is essential because ownership of gold in India is widely dispersed across geographies and across socio-economic classes, with rural India holding the major share. The initial challenge is one of logistics, identifying the assaying agencies for ensuring the purity of the ornament. There are banks and many non-banking financial companies (NBFCs) with the expertise to act as collecting agencies. Gold loan NBFCs would even be willing to underwrite the purity of the gold they collect.

With a retail collection infrastructure in place, it becomes possible to accept investments as low as 10 grams. The bigger challenge is to get people to lease out their gold to the government because melting ornaments into bullion involves a loss of up to 15-20 per cent to the investor. A higher rate of interest along with longer lease tenures of 5-10 years is the surest way to steer investments into the scheme.

However, it calls for a radical departure from the current thinking. Extant gold deposit schemes have floundered because returns are abysmal. The State Bank of India, for instance, offers 1-1.5 per cent even as the minimum deposit is pegged at a forbidding 500 grams.

Ideally, returns should be kept flexible, in step with the severity of the imbalances in our external account. In other words, higher interest rates on gold mobilised during times of stress, and lower rates during periods of stability. India's banks now offer an interest rate of 5.77 per cent per annum on five-year US dollar-denominated foreign currency non-resident (FCNR) deposits. Every tonne of gold mobilised thus saves an import bill of $40 million. Therefore, gold marshalled under the scheme should be accorded the status of "quasi-dollar" and offer returns equal to FCNR deposits of equivalent tenure.

Interest for Keeps

Interest will be payable on the value of gold assessed at the time of investment and remains unchanged for the full tenure. Importantly, unlike FCNR deposits, the interest amount won't head out of India. Every dollar saved on the import of gold contributes to a more manageable current account deficit. As outflows fall, the rupee holds its value better. It has a positive spin-off on both inflation (lower prices for petroleum products) and on the fiscal deficit (lower subsidy burden from under-recoveries).

Quick Redemption

Can the government meet the eventual redemption without suffering losses from adverse price movements? One way is to keep a reserve, say, 20 per cent, of the collected gold, and stipulate a minimum lock-in tenure of five years or more. Higher tenures may be offered, for example, by linking it to the age of the girl child in the family, to strike a chord with investors. Once the scheme stabilises, expect steady inflows to counter the redemption outflows.

Should there be a serious mismatch, inflows can be stimulated by recalibrating interest rates. Finally, Reserve Bank of India itself sits on over 550 tonnes of gold that could be used for redemptions in the worst-case scenario.

(The writer is executive director and deputy CEO, Manappuram Finance. Views are personal)

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