n early 2004, Arun Jaitley, the then union commerce minister, announced in his trade policy that ‘gold could be freely imported into India’. He clarified then ‘even a roadside paanwala will be able to import gold’. However, the Reserve Bank of India (RBI), the last word in matters pertaining to gold, took steps to guard its turf and raised several issues on the matter. Then, with the ‘India Shining’ campaign failing to take off, the NDA government lost power and the next government that lasted two terms did not pursue the matter and the idea was nipped in the bud.

Jaitley returned as union finance minister in May 2014. Therefore, much was expected from him by the gold industry that was reeling under the measures taken by the UPA government to keep CAD under control (this has been discussed in earlier issues of Solitaire in detail). However, apart from doing away with the 80:20 scheme of gold import-export last year, the new government did nothing to help the beleaguered gold trade. Import duty on gold continues to be abnormally high at 10%. The union budget in February 2015 appeared to promise ‘achhe din’ for the gold trade.

Industry observer SANJIV AROLE analyses in depth the viability of the Sovereign Gold Bond scheme proposed by the government.
while announcing a slew of measures to set things right for the bullion industry. Will the finance minister deliver on his budget promise this time around or will matters pertaining to gold remain just a ‘letter of intent’?

The salient features on the finance minister’s intent are given below with comments in italics.

(a) The finance minister proposed to monetise the 20,000-plus tonnes of gold in Indian households. This would attract interest for the depositor of gold. And this gold would be used for replacing the existing gold deposit scheme as well as the gold loan by banks. Jewellers would be able to obtain loans in their metal account and banks and other dealers would be able to monetise this gold.

However, the budget was then silent on how the finance minister proposed to achieve this.

(b) Develop an alternative financial asset, a Sovereign Gold Bond (SGB) as an alternative to purchasing gold. The bonds carrying a fixed rate of interest would be redeemable in cash in terms of face value of the gold, at the time of redemption for the bond holder.

Here too, the road map was not seen. It was not clear if such a bond would be backed by gold, either at the time of purchase or redemption. The only connection the scheme appeared to have with gold was the gold price.

Agency: (i) Bonds will be issued on behalf of the Government of India by RBI. (ii) Issuing agency will need to pay distribution costs and a sales commission to the intermediate channels, to be reimbursed by government.

Sale to Indian entities: The bond would be restricted for sale to resident Indian entities. The cap on bonds that may be bought by an entity would be at a suitable level, not more than 500 grams per person per year.

Features: (a) The government will issue bonds with a nominal rate of interest (which will be linked to international rate for gold borrowing). An indicative lower limit of 2% may be given but the actual rate will have to be market determined. On maturity, the investor receives the equivalent of the face value of gold in rupee terms. The rate of interest on the bonds will be consulted during the implementation of the proposals. The fear then was that the proposals would not yield the desired results and go the way of previous attempts to monetise gold with gold bonds.

Since then, the finance ministry has put up on its website draft proposals for the Sovereign Gold Bond as well as the Gold Monetisation scheme for discussion, comments and debate. In this issue, the Sovereign Gold Bond scheme will be analysed. The Gold Monetisation scheme would be analysed in the next issue.

The salient features of the SGB (put up only for discussion) are given below:

Draft outline of the Sovereign Gold Bond Scheme
(For discussion purposes only)

Introduction: Sovereign Gold Bonds will be issued on payment of money and would be linked to the price of gold.

Objective: Need for a Sovereign Gold Bond: (a) the main idea is to reduce the demand for physical gold. (b) Shift part of the estimated 300 tonnes of physical bars and coins purchased every year for Investment into ‘demat’ gold bonds.

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be payable in terms of grams of gold. The interest will be calculated on 10,000 at a certain percent say 2-3%. (b) The price of gold may be taken from NCDEX/ London Bullion Market Association/RBI and the rupee equivalent amount may be converted at the RBI Reference rate on issue and redemption. Banks/NBFCs/Post Offices may collect money/redeem bonds on behalf of government (for a fee, the amount would be as decided). (c) The bonds will be issued in denominations of 2, 5, 10 grams of gold or other denominations. (d) The tenure of the bond could be for a minimum of 5 to 7 years so that it would protect investors from medium-term volatility in gold prices. Since the bond will be a part of the sovereign borrowing, these would need to be within the fiscal deficit target for 2015-16 and onwards. (e) Bonds to be used as collateral for loans. The Loan-to-Value ratio to be set equal to ordinary gold loans mandated by RBI from time to time. (f) Bonds to be easily sold/traded on commodity exchanges. (g) KYC norms to be the same as that for gold. (h) Bonds to have a sovereign guarantee. (i) Capital gains tax treatment will be the same as for physical gold. This will ensure that an investor is indifferent in terms of investing in these bonds and in physical gold – as far as the tax treatment is concerned. This is still under examination.

**Hedging:** (a) The agency issuing the Sovereign Gold Bonds will be running a price risk on the amount of bonds issued. The price risk will comprise the price of gold in USD and the USD/INR exchange rate risk. Hedging of this risk is expensive and since the agency is the sovereign, and the amounts expected may not exceed 50 tonnes in the first year, may not hedge it. However, it should be cognizant of the existence of this risk. (b) Upside gains and downside risks will be with the investor and the investors will need to be aware of the volatility in gold prices. (c) The government would bear the risk of gold price movement on issuances.
Marketing: In order to ensure wide availability the bond will need to be marketed through post offices and by various brokers/agents who may need to be paid a commission (like for Kisan Vikas Patra).

Operational issues: Based on the current market price, issuance of gold bonds equivalent of 50 tonnes would be around ₹13,500 crore. Since the amount is not very high, it can be accommodated within the market borrowing programme for 2015-16.

So, is the Sovereign Gold Bond viable?
The primary objective of the Sovereign Gold Bond is to reduce the demand for investment in physical gold in bullion form (bars and coins). The attempt is to shift part of the estimated physical demand of around 300 tonnes of gold in form of bars and coins annually into ‘demat’ gold bonds. What must be borne in mind is that India’s share in the global demand for gold bars and coins was on an average 35% (2004-2012) of the global demand of over 1,000 tonnes. Although this share fell sharply last year to around 19%, that was more on account of the stringent measure imposed by the government to overcome CAD-related issues. It may at best be termed as an aberration that could turn around once normalcy is restored in the Indian gold market. But, given the Indian affinity to store gold in physical form and the none-too-impressive performance of gold ETFs in India as compared to international trends, the task is not an easy one. Moreover, given the fact that there is a strong investment motive even for buying of gold jewellery, the task assumes herculean proportions.

Let us first look at positive aspects of the SGB and why it is different from earlier schemes that the government proposed for gold deposit schemes, bonds, etc. The SGB is to be sold by the RBI on behalf of the Government of India and will have sovereign guarantee. The distribution and sales commission costs, etc. are to be borne by the government. The SGBs are to be sold to resident Indian entities with a cap of 500 grams per person per year. The bonds issued would get a nominal rate of interest (with a lower cap of 2%) linked to international gold borrowing rates. However, the rate would be market driven. There are many who believe that the rate of interest should be the same as savings bank interest rate, while others feel that it should be the same rate that is charged on gold loans in India. There are still others who opine that the interest rate should be at par with 5-year fixed deposit rates. Overall, it seems that the general feedback is a higher rate of interest rather than the minimum of 2% indicated in the draft proposal. The tenure of SGB should be between 5 and 7 years. Here too, the general feedback is that the tenure should be below 5 years. On maturity, while the face value is to be redeemed in cash, the interest portion is to be made in grams of gold. That is the only connection with gold in the SGB apart from the gold price. The SGB is to be issued in 2, 5, 10 grams and other denominations of gold. The SGB seems to be targeting the smaller investors for the first time unlike earlier schemes. Moreover, the timing is just right for investors looking for an alternate to the now unattractive monthly savings schemes run by retailers that were very popular till recently. These schemes, run by retailers, were offering attractive (around) 18% annualised returns. With a cap of 12% by the Companies Act 2013, these schemes have lost lustre and retailers too have seen their cost of production go higher as they are not getting cheaper finance from customers. Moreover, the 5-7-year tenure ensures that the investor is protected from gold price volatility in the medium term. The SGBs can be used as collaterals for loans and traded/sold on the commodity exchanges, implying the transferable nature of the bonds. The above factors could make the SGBs very attractive to small investors in physical gold who buy it as a form of saving. As most of the costs and risks are borne by the government, one can safely predict that SGBs could
who invest in physical gold do so in cash as they do not want an audit trail. In rural India with most investors having agricultural incomes, the question of black or white money does not really matter to them. Therefore, getting investors from rural India to invest in SGB would be a tall order indeed. In urban areas, the die-hard investors in physical gold who do so to park their funds in gold will not be easily swayed by the SGB. There are many professionals like doctors, lawyers, architects, engineers and a host of traders as well who earn their livelihood in cash, and would find it easy to invest in physical gold than in the SGB. As a result, they can escape the tax net by investing in physical gold bought in cash.

However, stock market investors who want to diversify into gold as a safety net (by investing 10-15% in gold) and gold ETF holders could be lured to SGB as it seems a far more attractive and cheaper option to invest in gold.

It is also pertinent to note that the Sovereign Gold Bond has very little connection with gold save the gold price and a mere 2% or slightly higher interest on monies invested in SGB in the form of gold. With a modest expectation of ₹13,500 crore in the year 2015-16, there is no question of backing the bond with gold or even hedging against any metal or price risk by the government. To some extent, the nomenclature Gold Bond in SGB is a misnomer. It would be very difficult to change the mindset of those who want to invest in physical gold. Tax implications may be the primary reason to invest in physical gold, but tradition, culture and the fact that gold has in the past acted as a safety net in times of need could become a major obstacle for SGB.

Moreover, the gold consumer is more comfortable with the jeweller in matters pertaining to gold. In some cases, the relationship goes back a couple of generations at least. There is a trust in the jeweller whereby consumers (mainly in rural India and smaller towns) will be more comfortable saving for gold with a retailer or even deposit gold with him. Poor banking penetration means that the level of trust is not the same with a banker or even a post office. However, over a period of time, the postman or the postmaster could develop trust with consumers when they trade in gold with consumers on a regular basis. But, that has still a long way to go. The government would do well to involve the jeweller in matters pertaining to gold. It could be for the SGB or the monetisation of gold or even marketing of gold coins. One must involve jewellers if the SGB and other schemes are to succeed.

There must be some sort of an incentive for consumers to invest in SGB (as well as other gold related issues). The jeweller should also be offered an incentive to push SGB, the gold monetisation scheme, and the official gold coin. The incentive for the trader could be lower import duty on gold if certain targets are met for SGB, etc. The consumer should also be getting an incentive for not investing in physical gold.

It is pertinent to remember here that the 10-tola bars manufactured solely for the Indian market were easily transported...
across borders by smugglers. Smuggling became unviable when pre-numbered gold bars of metric weight attracted a lower import duty of ₹100 per 10 gms as against ₹250 per 10 gms for other bars like the 10-tola bars. There must be similar such incentive if any of the new schemes, be it the SGB, the gold coin or gold monetisation scheme have to succeed.

The SGB could do well in a bull market. The investors could benefit from price appreciation along with the interest component. However, in a bearish phase with the gold price declining to new lows every other day, the investors could be wary of the scheme and may keep away.

Market reactions to the SGB indicate that the SGB needs to be tweaked as well. Some argue that equity mutual funds as well as pension funds should be allowed to invest in SGB. Then, there is also a view that the Loan-to-Value ratio of these bonds should be higher than those set for gold loan schemes by non-banking financial companies (NBFCs), as these are sovereign bonds.

Finally, the SGB as well as the Gold Monetisation scheme is to be put up before the cabinet anytime now. However, one still cannot set a time frame when the schemes will actually be implemented. In the past, too, India first allowed legal import of gold after the abolition of the Gold Control Act, but the structure of import duty and Special Import Licence (SIL), etc. took almost a year to be set in place. Then, the gold bond scheme in the 1990s was announced in a budget, but the actual scheme was rolled out in the next budget. The finance minister who has to push the schemes through has his hands full in the monsoon session of parliament. First of all, the parliament has to function. The finance minister is pre-occupied with Lalitgate, the Vyappam scam in Madhya Pradesh as well as the sticky issue of ‘chikks’ in Maharashtra. With even Amit Shah saying that it would take five terms (25 years) in power to turn things around, ‘acche din’ are still not on the horizon. For the gold trade, the wait could be even longer.

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Gold’s fate hangs in the balance

Gold nosedived below the $1,100 per ounce mark on news from China of the yellow metal’s 5-minute sell-off on the Shanghai commodity exchange in the middle of July. Further, news from China indicated that the increase in gold holdings with the Central Bank of China were half of what market experts expected. Then the resolution of the debt crisis in Greece, albeit of a temporary nature, and the US-Iran nuclear deal meant that quite suddenly there was no pressing crisis apart from the IS crisis in Iraq, Syria and other areas in the world that could push investors to look at gold as a safe haven. Gold slumped to five-year lows of around $1,080 per ounce and it remains below the $1,100 per ounce at around $1,095 per ounce on July 28, 2015. So, what are the implications for the gold price in the near future? What will be its impact on the demand for gold in India for the remainder of the year?

The stronger dollar, recovery in the US, lower oil prices, the impending hike in US interest rate by the Fed coupled with fewer troubled spots around the world, the fact that the eurozone crisis is stalled for the moment, and global equities showing an uptrend to some extent, all of which suggest lower gold prices in the future. Some predict even sub-$1,000-per-ounce levels in the near future. Philip Klapwijk, of Precious Metals Insight opines, “I think this break is for real and that we will not regain $1,145-1,225-per-ounce levels, but rather move much lower. In the shorter term, a rebound to $1,130 is feasible, but in my view the direction of travel in the medium term is lower, albeit probably not below $1,000. Of course, where the floor lies will depend, in part, upon how India and China react to lower prices. My assumption is that demand in India will pick up strongly, maybe +/-4% this year and 7% in the next year, assuming the price remains below $1,100 per ounce; we may see even $1,040 per ounce.’’

There are others who do not subscribe to the above theory. The opinion here is that gold prices have more or less bottomed out. Once the overhang of the US interest rate is out of the system (i.e., the hike actually takes place), then with the load off the shoulders, gold could regain its lustre and move back towards $1,300 per ounce or beyond, even as high as $1,500 per ounce in the next year. The sudden meltdown of the Chinese equities on the bourses could make things very tricky for gold. First, there could be a rush to gold as an alternative in China, but a serious decline could erode wealth and thereby reduce purchasing power there. That, in turn, could affect demand for gold.

As far as India is concerned, lower prices could spur demand for the yellow metal initially. The sharp decline in the gold price in July did see some initial demand coming to the surface. In fact, most jewellery companies on the stock market showed a sharp rise in their share prices as many investors felt that demand for gold would shoot up in the remainder of the year if the price continued to fall. There is a school of thought that sees demand for jewellery going up and expects investment demand to fall further. They feel that this trend is likely to continue in future and demand for bars and coins decline even further. In the last year or so, the share of bars and coins in the demand equation has declined quite significantly. However, this was more due to the stringent measures taken by the government to overcome the CAD crisis.
The 10% import duty coupled with CAD led to measures that skewed both the demand and supply sides of the equation. The increase in smuggling, round-tripping and the 80:20 scheme of import-export all combined to make the supply numbers more of an estimate than an absolute hard number.

Likewise, demand numbers are mere estimates that are further skewed by scrap estimates that are likely to be shown higher by the trade in order to accommodate smuggling numbers. Therefore, one has to be very cautious while accepting estimates given out by the trade.

In the past 12 months, even though there were restrictions on import of gold coins and bars for investment purposes and many entities like banks and even jewellers stopped selling coins and bars, one has to take investment demand numbers with a pinch of salt. For, although the demand for bars and coins were lower than earlier years, the fall may not have been so steep, given the fact that local refiners continued to satiate consumer demand for bars and coins. Investors are now more aware and prefer to invest in bars and coins either solely for investment purposes or to make jewellery at a later date. With changing fashion trends it makes little sense to make jewellery for marriage purposes well in advance. For, selling jewellery and making a new piece is a very costly affair indeed.

The first half of 2015 has not seen robust demand for gold. Reports indicate that the months of April and May were not particularly good for gold, in spite of that period being the peak marriage season. Therefore, the trade was very excited at the prospect of vigorous demand emanating due to lower gold prices. Although, there was some initial interest shown by consumers, that excitement appears to have died down.

Gold seems to be vacillating between the $1,100 and $1,085 per ounce range. Moreover, the weaker rupee means the rupee gold price has not really crashed below ₹24,000 per 10 gms yet. While many expect lower gold prices in the coming months to spur higher demand for gold, there is still a possibility that should the gold price fall sharply and continue its downward slide, one could see panic selling by investors. For, there were many investors who have invested in bars and coins post 2007 following the steep rise in prices till 2012. These investors may panic if they see the value of their investments erode before their very eyes. Since 2008, Indians have invested around 1,500 tonnes in bars and coins (data GFMS). Falling prices could cause this overhang to upset the whole equation. Gold is precariously perched!