

**The Twelfth  
DR. AMITABH CHOWDHURY ANNUAL MEMORIAL LECTURE**

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**GOLD POLICY IN INDIA**

Y.V. Reddy

Respected Family Members of Dr. Amitabh Chowdhury, eminent and distinguished members of the audience, and dear friends. At the outset, I express my regrets that I don't have the pleasure of physically being with you. However, I have prepared a speech, I had sent it across and I am sure, that it will be distributed at the end of the Lecture. I will also take some questions and answers if time permits.

At the outset, I must convey that, I am grateful to the eminent and distinguished Trustees of Dr. Amitabh Chowdhury Memorial Trust, for conferring on me the privilege of delivering the Twelfth Dr. Amitabh Chowdhury Annual Memorial Lecture.

All of us must be grateful to Amitabh's parents, Srimati Biraja Chowdhury and Shri Dhires Narayan Chowdhury for the services the Trust is rendering. The Trust has several commendable programmes as part of their outreach. Memorial Lecture is but one part of the activities.

Dr. Amitabh Chowdhury symbolized all the great qualities that are expected from an ideal human being. I understand that he was full of magnanimity, compassion, integrity, uprightness, steadfastness and dedication to his profession.

Obviously, he embodied all the characteristics of a true yogi. Hailing from East India, Amitabh did schooling in Gauhati and Shillong. He blossomed as a medical Doctor in Guwahati, improved his skills in New Delhi, completed a programme in Kanpur, and proceeded to work in Chennai. Thus, his skills as a surgeon tempered with his compassion and personal warmth, were felt not only in Guwahati, but in many parts of India.

It is not surprising that the Memorial Lectures have been delivered by distinguished people drawn from different parts of India, and with different backgrounds. This is consistent with what Amitabh stood for, both in words and deeds. It is, therefore, a great honour for me to be here to recall and pay respects to the values that Dr. Amitabh Chowdhury cherished.

### **Surgeons and Central Bankers**

Some of you may be wondering what a central banker like me has in common with a surgeon, like Dr. Amitabh Chowdhury. Let me give a quote from a book titled **“STRESS TEST: Reflections on Financial Crisis”** (published by Crown Publishers, New York, in 2014) by Timothy F. Geithner, who was Chairman of Federal Reserve of New York at the time of financial crisis in 2007 and later Secretary of Treasury in U.S.A., who is equivalent to our Finance Minister.

“Y.V. Reddy, India’s central banker, gave me a book during the crisis called *Complications: Notes from the Life of a Young Surgeon*, by Atul Gawande. He told me it was the best book I would ever read about central banking, and the parallels with financial crisis management really are striking. It’s about making life-or-death decisions in a fog of

uncertainty, dealing with the constant risk of catastrophic failure. It's not a coincidence that after the crisis wound down and I started watching some TV again, I got into *House M.D.*, the series about a misanthropic doctor who leads a team focusing on mysterious medical cases. I could relate—not to the misanthropy, but to the complex problem-solving, the inevitable complications, the team sitting around a table debating diagnosis and treatment.

That's financial crisis management, more or less. Its diagnosis and treatment, prevention and cure, triage and surgery. The stakes are high and the outcomes are uncertain. Every case is different, but some protocols can be applied broadly."

Mr. Geithner thanked me profusely for suggesting the book by the young surgeon. In fact, he tracked Dr. Gwande. In brief, we central bankers have some things to learn from surgeons.

### **Subject**

I have chosen a somewhat unusual subject for a Memorial Lecture, namely, Gold, because humanity is obsessed with it. Gold has a special place in the lives of Indians; and more recently, public policies are focused on it. Above all, in India, it is often, unfortunately linked to black money, the bane of India. And, there is a fog of uncertainty in our policies dealing with both gold and black money.

The story of Gold in human history is fascinating, and I will not go into it. To those who are interested in Gold per se, I recommend a reading of the book: "The Power of Gold: The History of an Obsession" by Bernstein, Peter L.

In India, Gold has a very special place in the lives of people. Yet, for several years since Independence, Government of India has been trying to regulate, control and mobilize gold with the people for a variety of purposes, keeping in view the public interest. What is the public interest?

We do not produce gold domestically, except very little, if at all. So the policy is concerned about the cost of importing gold. Many economists felt that investment by poor people of India in gold represents unproductive use of the savings of the people. One of the objectives of the policy has been to dissuade people from hold gold. There are concerns that investment in gold is one of the forms in which black money is held, and for this reason also some feel that gold trade should somehow be discouraged.

Gold policy has been revisited recently for several reasons. Will the recent policy be more effective in tackling black money? What is the way forward? I hope to share some thoughts on these issues with you today.

### **Supply**

What are the sources of supply of gold to people in India? The domestic production of primary gold is insignificant. So, import of gold is substantial. This has a large impact on balance of payments. There is certain amount of recycled gold available within the country usually through jewellery trade. The supply of

gold through imports that is meant for the exports does not add to any burden on external sector and since value added is small in this process, we need not take this into account for assessing the supply and demand factors in regard to gold economy in India.

The bulk of the supply of gold in India's gold market is through import, and it can be through what may be called 'official channels', where it is accounted for in the balance of payments data. It can also be through non-official channels which is called 'gold smuggling' in common parlance.

The supply of gold through official channels relative to non-official channels depends on the public policies relating to the import of gold. If import of gold is not officially permitted, as it was several years ago, the import of gold is through non-official channel. If the import duty is high, then there is a significant import of gold through non official channels.

It is true that whenever there was an increase in import duty, there was reduction in imports till alternate arrangements were made by the parties concerned to shift to non-official channels. So, one should not generalise about effects of duties on imports on the basis of immediate impact.

Given our past experience, is it realistic to assume that gold smuggling can be effectively stopped or significantly reduced through administrative machinery, or through high duties?

From macro-economic point of view, Indian economy will have to pay for all gold through exports or capital inflows. The payment for imports through official

channels is through official forex market. Import of gold through non-official channel is funded by non-official channels such as under-invoicing or over-invoicing of exports and flow of remittances through, what is known as 'hawala transactions'.

## **Demand**

What are the sources of demand? The demand for imported gold in India arises partly for jewellery exports and mostly for domestic absorption. The demand for re-export may not be taken into account for purposes of analysing net impact on domestic economy except to the extent of net export earnings and employment implications. So, let us consider the nature of demand for gold for domestic absorption in India.

The demand for gold in India has been a historically recognised fact and persisted over centuries. There was a reference to the imports of gold in the discussions among Senators of Roman Empire. Senators complained that Romans were importing many commodities from India and paying for it with valuable gold that Romans had to acquire. In other words, the demand for gold in many ways is a part of tradition and culture in India.

The demand for gold arises both as a consumption good when gold jewellery is used and as an investment good when it can be sold and till then kept as a form of savings. In a way it is, in many, if not all cases, both an investment good and consumption good.

In view of the traditional attachment to gold the aggregate demand for gold increases with increase in population and income. Both population and incomes

have been and are increasing in India. Hence, in the absence of drastic change in the tradition, there is an understandable persistent increase in demand for gold. Almost all of additions to demand for gold have to be met through import of gold for Jewellery.

In a few cases, investors invest in gold if they find that equity markets are sluggish or bank interest rates are low. These are often in the form of Gold bars or coins. However, there is significant anecdotal evidence to show that gold is one of the means of stocking black-money or unaccounted money. If the share of black-money in India increases, it is possible that demand for gold, particularly for investment purposes tends to be higher.

In brief, a large part of demand for gold is tradition based, and some part of it for other reasons, especially to store black money. Gold Policy, should ideally address the issue of demand for gold on both counts.

### **Gold Policy: Review**

The evolution of the gold policy since independence centered around five main objectives, viz., to wean people away from gold; regulate its supply; reduce smuggling; reduce demand; and, reduce domestic price of gold. The first major effort to mobilise the vast gold reserves in the country was issue of 15 year Gold Bonds at 6.5 per cent in November 1962. To control the diversion of savings into bullion market, gold control rules were promulgated in January 1963. Control over internal trade and distribution of gold was fully established in 1964. A second attempt was made to issue Gold Bonds in 1980. A third series of Gold Bonds designated as National Defence Gold Bonds was issued in October 1965. The

voluntary disclosure scheme of 1975 granted immunity from Gold Control Act. In 1978-79, gold auctions were undertaken as an anti inflationary measure and to curb smuggling. These were discontinued expeditiously. A Gold Bond scheme was launched in 1993, which garnered 41 tons of Gold, easily the highest mobilised among all the Gold Bond schemes till then. There was a Gold Deposit Scheme in 1999 and it yielded insignificant amounts.

A number of Expert committees have gone into this issue. These include a Committee headed by Dr. I G Patel, Governor in 1978. It is interesting to note that the Committee said: "The question of issuing Gold Bond was examined, but not favoured since this would in effect amount to indexing the value of the savings of those who want gold as a hedge against inflation, as compared to the savers who are willing to hold other financial assets." Subsequently, a working group to review gold policy was appointed in 1986 under the Chairmanship of Dr. Rangarajan. The RBI came out with a discussion paper in 1992 on this subject. A suggestion was made to set up a Gold Bank with the objective of mobilising domestic non official gold holdings, and channelize them into a centralised pool over a period of time, and deploy them in a productive manner for the development of the country. However, this was not accepted.

We in Government and RBI, reviewed gold policy as part of reform after the balance of payment of crisis in 1991. We noted that we had severely restricted the import of gold for years before the crisis, but and yet the crisis occurred. There was also a realisation that all the efforts to curb smuggling of gold were almost totally ineffective. We realised that large scale smuggling of gold was possible only

by paying for it through unofficial channels. It meant that policies in regard to foreign exchange rates of Rupee will be undermined by the unofficial channels of importing gold and financing of such imports. Hence, a decision was taken to officialise gold imports so that international transactions relating to gold also become part of foreign exchange markets and thus amenable to policy intervention by the Reserve Bank of India. It is in this background that import of gold was permitted freely. However, import had to be mainly through authorized banks only, and a nominal duty was levied on imports. So, we had an interesting reform where import of gold was liberalised as a solution to balance of payments problems! The import of gold was permitted through select banks and MMTC, at a nominal duty. The policy has continued since then with occasional temporary increases in duty or other restrictions.

In 2012, RBI constituted a Working Group on issues relating to gold and gold loans by Non Banking Finance Companies with K.U.B. Rao as Chairman. The Committee submitted a report in 2013, which dealt extensively with both macro and micro issues. Several policy actions were recommended. No significant follow up actions on the Report are in public domain.

### **New Policy Initiatives**

The Government of India has very recently launched three schemes, viz., Gold Coin Scheme, Gold Monetisation Scheme and issue of Sovereign Gold Bonds. The three schemes introduced in November 2015 are landmark in the sense that the Government has attempted to device the schemes that meet different needs of consumers. These schemes together have been described as path breaking. It

could have far reaching implications depending on the manner in which they are operated.

Gold Coin Scheme provides an opportunity for individuals to acquire gold coins with assured quality. They can be purchased and can also be sold at the prevailing market value. They are made available through banks, selected jewelers and even through e-commerce companies. It is certainly an attractive form for individuals keeping savings in the form of physical gold with characteristics of liquidity and authenticity. It may replace the gold coins currently in the market mostly available with Indian Gods engraved on them. In such an event, there may not be addition to total demand for gold. But, because of authenticity and quality, there could be additional demand for gold on this account. It provides a facility for the citizens who want to hold authentic gold, and to that extent, may be welcome. This scheme by itself may not reduce total holding of gold in India.

The Gold Monetisation Scheme involves banks. Under the scheme, holders of gold in India may deposit their gold in the banks. The gold which may be in the form of jewellery will have to be melted for this purpose and made into standard quality by authorized agencies. The depositor would get a certificate about the gold deposited. It can be deposited for varying maturities. Both the principal and the interest will be repaid on maturity of the deposit in terms of gold or money equivalent to the market price of the gold at the time of redemption.

From the depositor's point of view, it is advantageous to the extent that the value of the gold is protected and interest is also obtained. However, the depositor has to convert existing jewellery into gold for deposit purpose and will have to

convert back into jewellery on maturity of the deposit. It is not very clear how many individuals who have gold in the form of jewellery now would be willing to go through the process of conversion, and in some cases, reconversion. If the Gold Monetisation Scheme is made very attractive, people may be tempted to buy gold and deposit it in the banks. In that case, demand for and import of gold may not be reduced.

From the banks' point of view, there may be some issues. The bank should be able to seek and match borrowers for the gold deposited with it. Any mismatch will involve a cost to the bank. In the normal course, it may be difficult for the banks to bear such risks unless special dispensation is given, but then the issue is whether such special dispensation has corresponding advantages. Advantages may accrue if it is assumed that some part of existing stock of gold would be reduced and no addition to stock will take place.

Over all, considering the logistics and the costs involved in the transformation of gold into money and vice versa, it is possible that this scheme would be attractive only to those who have large quantities of gold with them provided such gold is also fully accounted for. Perhaps, gold held in trusts and temples will take advantage of this. This scheme does not address the issue of black money.

The Sovereign Bond Scheme is essentially like any other bond issued by the Government, except that it is denominated in grams of gold instead of rupees. In this scheme, the investors will buy the bond by paying rupees and also redeem the bonds by getting cash on maturity. However, the denomination of the bond is in

grams of gold and, therefore, the transaction will be in terms of value of gold in rupees at the relevant time. The bond is issued by Reserve Bank of India, but it is actually on behalf of Government of India.

The Sovereign Bond Scheme is a good option for those who would like to invest in physical gold purely in the form of investment of their savings. Instead of physically holding the gold, they have the monetary benefit of holding such gold. Those who are purchasing the bond are, in a way, taking the risk since even the capital may be lost if the market price of the gold declines, but the units of gold would remain the same. They will gain if prices of gold increase at the time of redemption.

How will one know in advance, whether price will increase or not? It is almost impossible to predict. But, I can give an illustration. The value of the gold holdings with Reserve Bank of India was 557.75 tonnes, equivalent to U.S. \$ 28.66 Billion in October 2011. On 13<sup>th</sup> Nov. 2015, it was valued at 18.69 Billion. There is, therefore, a capital loss of 35 per cent in terms of U.S. \$. However it may not be so in rupee terms. The rupee value of gold in India normally reflects the global price of gold expressed in terms of U.S. \$, and the exchange rate of the Rupee.

From the point of view of the Government, the income and expenditure of the Government is mostly in rupees. However, as far as the sovereign bond is concerned, Government will have exposure to the gold price and, thus, will be bearing some risk. This scheme is again in the nature of facility for investors who would like to have an instrument denominated in gold. If this instrument appears very attractive to the investor, it is possible that the attractiveness of similar

financial instruments denominated in rupee would be undermined. In other words, if there is a large scale success of the Gold Bond Scheme, the Government will be exposed to gold price risk, and it may find its own rupee denominated instruments undermined. The rupee denominated sovereign bonds provides the benchmark for all financial markets as it has to be the mainstay for market borrowings of Government. If those who are holding physical gold as an investment cease to do so, to invest in the bonds, demand for gold may be reduced. In a way, this scheme may be beneficial if it is confined to modest doses. This scheme also may not address the issue of black money.

### **Black Money**

Black money is closely related to gold market in India, to the extent a part of gold demand or supply may be dealing with black money. Demand for gold is both from honest tax-paying citizens and by those who want to transact in or store black money. Black money is both a stock and a flow. It is in the form of stock when it is invested in real estate, in gold, and in foreign assets. Depending on the tax systems and other legal frameworks as well as culture of compliance or non-compliance, black money may be generated, but once it is generated, it can go into the flow as well as into the stock, and keep flowing in and out of stock.

Black money is not exactly parallel with white money since there is continuous mingling of the two. For example, many buildings are constructed by real estate developers with a significant share of black money. The developer may be paying wages to the construction workers in the evening out of his black money. For the construction worker, however, it is white money earned for hard work, and

when he/she spends to buy the groceries in the evening, it is pure white money transaction. However, when the owner of the grocery shop has to pay protection money to the mafia in the night, it becomes black money with the mafia. At the same time, when the grocery shop pays electricity bill or pays municipal tax, they are all white money transactions. In brief, the black and white components keep changing through the transactions.

Black money which is in the form of foreign assets may not be held purely as bank deposits or in liquid form. Very often, there is a popular demand for bringing back the black money that has been (stashed) abroad. While the money at some stage could have been in a bank deposit, it is most unlikely that the foreign assets funded by black money remain un-invested in other financial instruments. In fact, it is quite possible that a large part of black money taken by resident Indians abroad, has been brought back through tax havens for investing in Indian financial markets. The current policy regime of portfolio flows provides ample opportunities for such "round tripping" of black money with considerable material benefit to those indulging in such round tripping.

Experience with tax amnesty to convert black money into white has not helped in curbing generation of black money. In fact, such amnesty has led people to argue that yesterday's black money can become today's white money if the policy of the government changes. In other words, the stigma attached to the black money and the differentiation on ethical grounds between black and white money, loses its significance with recourse to amnesty by the government. Both in

theory and in practice, both in India and globally, tax amnesty proved to be counter-productive.

### **Way Forward: Be Fair**

I believe that for policy purposes, merely because demand for gold is traditional, it does not mean that it is irrational or undesirable. Most of the traditional demand for gold originates from women in India, and this has to be appreciated in the context of absence of property rights for women on par with men in most of India. Even if there are legally equal property rights, women cannot in reality exercise them. Traditionally, gold is inherited among women. Women are deprived of their gold only under desperate circumstances. Gold provides safety and security for women, and under difficult circumstances liquidity. It is significantly non-depreciating in its physical form or in terms of value. It may appear inappropriate to discourage import of gold that meets needs of women, while import of luxury cars and men's shaving lotions are permitted freely. In view of these considerations, I feel that public policy in regard to gold should be fair to all, and not imply a bias against tradition or a bias against a gender.

It, therefore, appears that public policy should ideally address the three different sources of demand for gold in a differentiated manner. First, in regard to the demand arising out of cultural factors, property rights and general preferences, these will get resolved over the longer term depending on socio-economic developments. Second, the development of financial sector to provide reliable alternatives to gold as a form of saving for individual investors must be considered over the medium-term. Adequate returns for the savers through financial

instruments, especially bank deposits and mutual funds, deserve serious attention. Gold denominated instruments, if excessively attractive, may undermine the rupee based on financial intermediation system. That would not be conducive to a healthy and competitive financial sector which is essential for our economy. Third, the demand for gold arising out of black money transactions requires immediate and serious attention in view of its nefarious influence on economic system and social fabric.

Hence, the priority for public policy has to be attacking black money. That would require action on several fronts, mainly focussed on the incentives to generate black money. In a system that is fair and firm, there will be less scope for generating black money.

The tax system should be perceived as fair in order to ensure that there is tax compliance. For example, the dividends are exempted from income tax. In effect, this implies that richer people who would have paid higher taxes would be paying less, and the poorer people in the lower income bracket would end up paying more tax on their income from dividends. Another example relates to inheritance tax. There is virtually no major country in the world which does not have an inheritance tax. Another example relates to cross-border flows. If a resident Indian manages to take funds out of the country and invests through tax havens, there is virtually no tax. This is often referred to as 'round tripping' and this is widely prevalent.

There is a wide spread feeling that the tax system in India is not fair. It is undeniable that a large population with enormous riches are managing to escape

the tax liabilities sometimes through tax avoidance, and very often, through tax evasion. The administration of the tax system should be seen to be fair and effective if tax compliance has to improve.

Many public institutions could be redesigned and their functioning improved to effectively punish the wrong doers which itself provides incentives for doing the right thing. The institutions and procedures should not only enable honesty and efficiency, but increase the probability of being caught when a person indulges in wrong doing. It is also necessary to increase the probability of immediate prosecution and prompt conviction after being caught. A strong sense of right and wrong in the society is essential for public policy to move in this direction.

Black money is not a matter of concern for public policy only. Private sector also suffers in the process. Private sector has to admit its responsibility in generating and perpetuating black money. It is recognised that combination of politics and business has often been a hurdle to tackling the menace of black money in India. Public policies meant to tackle black money are often influenced by politics and business. As a society, we seem to be very tolerant to unfairness in politics and in business.

Let me conclude by submitting that public policies and, perhaps, public opinion, relating to gold and black money often ignore some fundamental human factors. We should not be judgemental about choices in favour of gold by our women folk. But, we should be severe in curbing demand for gold out of black money. But, black money itself is a complex subject. To curb the black money, we need to look at values such as fairness, and incentives.

We should understand the problems and address them despite fogs of uncertainty, and pursue the right path. This is exactly what Amitabh demonstrated in his life. He excelled in professional knowledge and skills; and lived a life of humanism and compassion.

Let me conclude by wishing the Trust all the very best in their noble and laudable initiatives towards a better society.

Thank you.