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Investment in Gold in Indian Scenario

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Abstract:

Gold has been the most preferred investment option across ages in Indian society. The investment in the yellow metal is not only an outcome of the traditional and sentimental beliefs attached to it, but also due to the inherent properties of it being an inflation hedge and safe haven. Apart from the traditional jewellery, the investment in gold can take up the shape of Gold ETFs, Gold SIPs, Gold Mutual Funds, so on and so forth. This paper attempts to summarize and analyse these various investment options available to the investors in Indian market. Moreover, gold imports being the cause behind trade deficit in the country, the paper attempts to correlate the same with investment products and concludes by suggesting some measures to reduce the same.

Keywords: Gold, Investment, E-Gold, Exchange Traded Funds (ETFs), Systematic Investment Plans (SIPs)

1. Introduction

Gold, the yellow metal, has occupied a central stage in the world of investment these days. The price of the metal is surging beyond the normal expectations and all this is causing a sense of urgency in the investors' mind to include gold in their individual investment portfolios. Gold plays a very important role in the social, religious and cultural lives of Indians. Moreover, Gold has been long regarded as a store of value, hedge against inflation and more importantly a liquid asset. This huge fascination for gold together with these features make it more attractive as an investment option leading to its high demand which is met by imports. It is interesting to note that gold accounts for the second biggest import after oil. This is the reason why India is the largest consumer as well as importer of gold in the world. According to a recent forecast by World Gold Council, India is set to touch 900-1000 tonnes of gold import in 2014. This indicates the fact that barring the fact that gold imports are the major reason behind widening Current Account Deficit and the government is taking crucial measures to curb them; Indians are still determined to consume gold. The investment in gold may take up various forms-be it the traditional jewellery or the recently introduced investment options like Gold ETFs or E-Gold. The objective of this paper is to explore the options available for investment in gold in India. The paper is organized as follows: Following the introduction, Section II lays down the review of literature. Section III discusses the demand patterns for gold in India in relation to the global supply of the metal. Section IV gives a brief idea about various investment options and the trend observed in their investment in recent years. The last section concludes and suggests measures to reduce gold imports through financial products.

2. Literature Review

Most of the studies in relation to gold have been regarding the macroeconomic determinants of gold. Adibe and Fei (2009) investigated the relationship between gold prices and macroeconomic variables for United States of America. The study found the existence of relationship between the price movement of gold, real interest rates and the exchange rate, suggesting a close relationship between gold and the value of U.S. dollar. Similarly, Batten et al. (2010) concluded that gold volatility is mostly explained by monetary variables such as inflation, interest rate and growth rate in money supply. While these studies relate to the developed economies, Trivedi and Bahera (2012) in India, found the existence of a long run relationship between gold prices and independent variables namely real GDP, interest rate, real effective exchange rate, equity prices and world gold prices. Their study established that exchange rate and world gold prices are the main determinants of gold prices in India. Lampinen (2007) examined the short- and long-run price determinants of the price of gold and found further evidence that gold can be regarded as a long-run hedge against the inflation and that the price of gold moves in line with the general price level. However, the movements in the nominal price of gold are dominated by short-run influences and that the long-run relationship has less impact at any given time. Chua and Woodward (1982) examined the effectiveness of gold as an inflation hedge for investors in six major industrial countries (Canada, Germany, Japan, Switzerland, UK and US) gold has been an effective inflationary hedge only in the US for the investors with investment horizon extending over one and six months. Years later, the study was extended by Beckmann and Czudaj (2013) as they analyzed the ability of gold as inflation hedge across four economies (USA, the UK, the Euro Area, and Japan) and found out that gold is able to partially hedge inflation in the long run especially in the case of USA and the UK. One of the key properties of gold is that it has negative correlation with the stock market. That is to say, when stock market goes down, gold investment goes up. Vuyyuri and Mani (2005) study indicated that stocks are not alternative to gold. Indians hold gold

because of their sentimental value attached to gold. In yet another study, Vaidyanathan (1999) found that demand for gold tends to be higher when domestic gold price rises relative to those of ordinary shares and international gold prices. Mukul et al. in their research concluded that gold investment gave a better monthly return as compared to a diversified equity fund. The study also supports the fact that gold has a negative correlation with equity investment and can act as a perfect instrument for hedging equity investment risk. Mulyadi and Anwar (2012) found that gold investment can be considered as a safe haven and perhaps a better investment than stock investment. Further, a recent study by Patel (2013) investigated the causal relationship between stock market indices and gold price in India. The study found that there exists a long run equilibrium relation between all the variables.

3. Demand for Gold in India

It is well known that the demand for gold in India is influenced by many social, economic and cultural factors. The price of gold, rural income distribution, quantum of black money, rate of return on alternate financial assets and the general price level are major driving factors for gold demand in India. One of the major components of gold demand in recent years has been investment demand at the global level. Rising gold prices in recent years did not deter the acquisition of gold in India, implying that investment in gold is becoming price inelastic. The performance of gold against other comparable domestic assets over the last few years is suggestive of the shift towards gold in India also.

Year	Global Gold Supply \$(Tonnes)	Gold Demand from India @ (Tonnes)
2006	3559	707
2007	3554	716
2008	3657	679
2009	4146	743
2010	4274	871
2011	4030	975
2012	4455	864
2013	4254	975

Table 1: Global Gold Supply and India's Demand for Gold

Source1: World Gold Council and Estimations from DGCIS Data; \$ Calendar Year; @ Financial year

As it can be observed from the close look at the data above, global gold supply has almost shown a flat trend, the demand for gold from India is on upswing. Even in the years when the growth in global gold supply has been weak, the growth rate of Indian demand for gold is strong. But on the downside, this increased demand for gold is contributing to widening current account deficit (CAD). Around 30 per cent of trade deficit is attributed to gold imports during 2009-10 to 2011-12. This has been the fundamental reason behind import duty rate hikes and other macro level measures to curb gold demand.

4. Rationale behind Gold Investment

Gold is considered to be a good investment option because it has below mentioned properties:

- Store of value- Gold maintains its value throughout the ages. It is a great store of value and a good way to preserve the wealth.
- Hedge against Inflation-Gold has historically been an excellent hedge against inflation, as its price tends to rise when the inflation is present.
- Crisis Commodity- whenever the world faces any kind of crisis, financial or political, the price of gold rises in such situation outperforming other investments.
- Portfolio Diversifier- Due to the negative correlation present between stocks and gold, it is generally preferred to include gold along with equities to diversify the portfolio to reduce the overall risk.

5. Investment Options in Gold in Indian Market

Having seen the upward trend in consumption of Gold, it is important to discuss about the various options available to the investor to invest in. apart from the traditional investment in physical gold jewellery and coins, investment options in gold can take up the shape of either gold backed investment products or systematic investment plans. There are also some lucrative options to monetize the physical gold.

5.1. Gold-Backed Investment Products

These products offer a platform of indirectly investing in gold i.e. one will not physically possess the gold but an equal value of gold will be parked in regard of the investment product opted. Thus, one could enjoy the benefits of physical gold and liquidity. In fact, on redemption, one could not claim gold in materialized form but the cash equivalent.

5.1.1. Gold ETFs in India

In recent years, Indian investors have started investing in gold exchange-traded funds (ETFs). The investors can buy smaller quantities of gold but are free from the hassle of storage and safety. These ETFs are akin to share of the company and are traded on stock exchanges. One of the key reasons behind the increased investment in ETFs is the ease and convenience of holding gold in demat form. Though the investors do not possess any gold themselves, regulators require a 100% gold reserve corresponding to the amount of investment. The increased demand for gold and investment in Gold ETFs thereof, can be seen from the quarter wise data collected from Association of Mutual Funds in India (AMFI) regarding the assets under management (AUMs) under gold ETFs. The data shows a steep rise in AUM till last third quarter of financial year 2012 and fluctuations thereafter. The widening Current Account Deficit (CAD) provoked the government to take measures to reduce gold investments and accordingly in 2013, the central bank barred the banks and non-banking finance companies from extending loans against units of gold exchange-traded funds (ETFs) and gold mutual funds. The decline in 2013 and 2014 is the result of such policy.

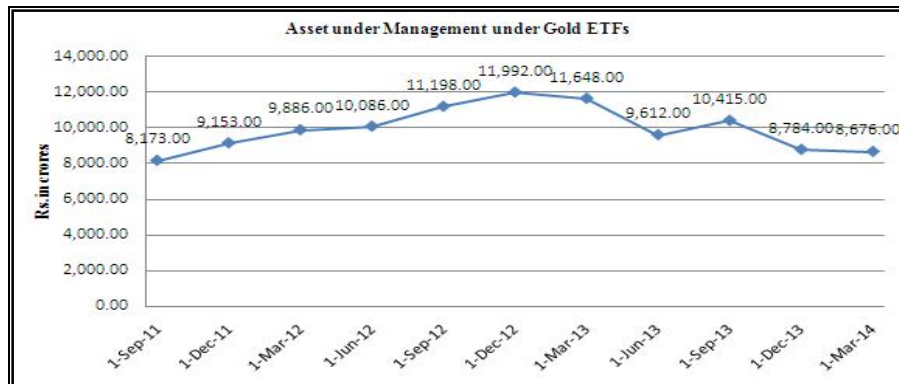


Figure 1: Asset under Management under Gold ETFs (Source- AMFI)

5.1.2. Gold Futures and Forwards

The derivatives market for gold is also a lucrative option to make an investment in. Gold futures contracts obligate the buyer/seller to take/make delivery of gold of a specified quantity and purity, at a predetermined date and price. These contracts are standardized in nature to facilitate trading on a futures commodity exchange (Multi Commodity Exchange in India). Some futures contracts may call for physical delivery of the asset, while others are settled in cash. The investors can make trading profits by understanding the perception of market about the carrying costs (cost of borrowing gold plus insurance and storage) involved at the future date. Similar to futures, gold forwards are contract between two parties to buy or sell gold at a specified price on a future date, but these are customized in nature. Futures contracts in gold carry the guarantee of the exchange on which they trade and are therefore risk free. Since the futures can be sold to third party before the maturity date, these are more liquid than the forwards contracts.

5.2. Gold Systematic Investment Products (SIPs)

A systematic investment product (SIP) is a regular and long term investment technique, wherein investor can invest in gold in small units regularly. The investor is required to set aside a sum of money every period (a month, quarter, half year) and invest the same in gold, regardless of its price. SIP inculcates a saving habit among investor who wish to accumulate the gold in small amount. It helps the investor to diversify the portfolio and get the returns from gold in long-term. SIPs are flexible in structure since an investor can either hold the gold-linked paper assets or lend out physical gold in the market.

5.2.1. Gold Mutual Funds

These are relatively new in the market as these were introduced three years back only and have only a few institutions offering the scheme. Gold Mutual Funds are fund of funds (FoFs) that invest in either their own Gold ETFs or a foreign Gold fund which is the mother fund. The investors can invest in these mutual funds without opening any demat account, which was prerequisite in Gold ETFs and can enjoy the exposure into Gold as an asset class. These mutual funds offer growth and income schemes or both. One can invest in these mutual funds through Systematic Investment Plans also.

5.2.2. E-Gold

This is relatively an innovative way of owning gold. Gold is stored in an online account and backed by gold which can be used or transferred to make payment. It can be easily redeemed into physical gold. The National Spot Exchange Limited (NSEL) has initiated Systematic Investment Plan (SIP) e-Series products to make it more investor friendly and to promote saving and investment among the retail investors. Among the different e-Series products the, e-Gold has seen an upswing in the turnover and trade volume in good numbers till 2012. However, both turnover and trade volume declined in 2013. This could be attributed to the successive import rate hikes in the year 2013 to reduce the rising demand of gold and stabilize the macroeconomic condition.

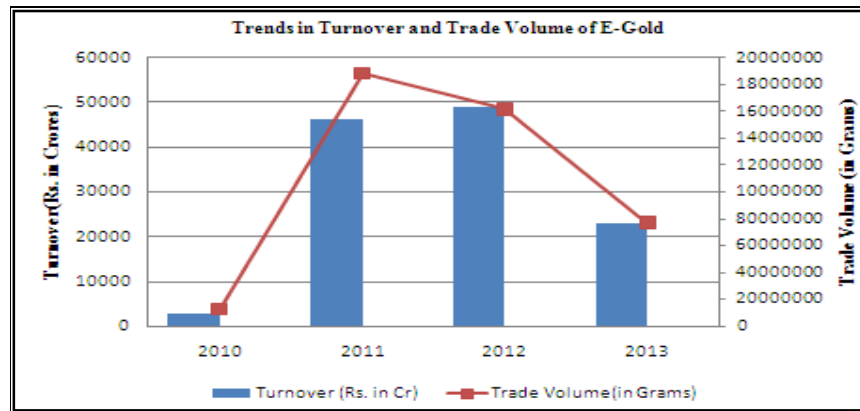


Figure 2: Trends and turnover volume of e-Gold (Source-NSEL)

5.3. Converting Gold into cash-Monetizing Gold

Gold can be monetized by converting the physical holdings into cash. The holder of gold can get loan against his holdings or get deposit certificates which is marketable security.

5.3.1. Loans against Gold

The most prominent mode that monetizes gold is the gold jewellery loan segment. As Indians own huge quantities of gold jewellery, the loan against gold makes good business sense. The gold loan segment unlocks the hidden economic value of the existing stock of physical gold, which is otherwise lying idle. It is a very useful concept of converting the physical savings into money. In India, a large number of banks and NBFCs are extending loans against the used gold jewels and ornaments at a specific loan to value ratio. There are several reasons for this sharp upward trend in gold loans in recent years. It is convenient tool for raising loans. Moreover, flexibility of loan options, liberal Loan to Value Ratio, easy to conform documentation led to expansion of gold loans and geographical expansion of gold loan companies also facilitated the loan delivery. The size of gold loans showed an upward trend due price increase of the gold and limited availability of retail and personal loans from banks.

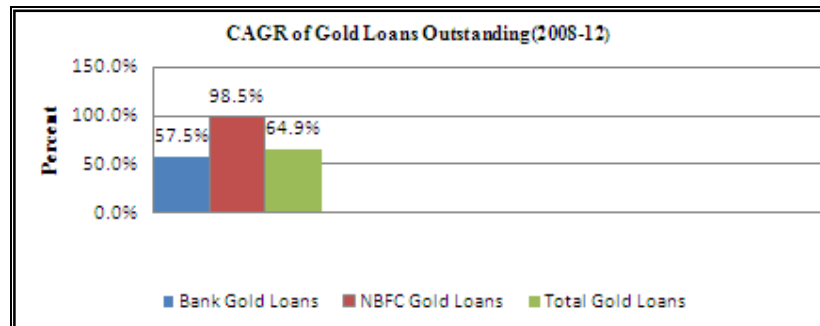


Figure 3: CAGR of Gold loans outstanding (Source: RBI)

5.3.2. Gold Deposit Scheme

Another good way to monetize the gold holdings in physical form or jewellery or bullion is to deposit the same with a bank and earn returns on them according to their grammage. The State Bank of India was the first to launch Gold Deposit Scheme in India. Individuals, HUFs, trusts and companies can deposit a minimum of 200 gm of gold with no upper limit, in exchange for gold bonds carrying a tax-free interest of 3 to 4 per cent depending upon the bond period ranging from 3 to 7 years. Furthermore, these bonds are free from wealth tax and capital gains tax. The principal can be collected back in gold or cash at the investor's option. This option got a limited acceptability from the Indian consumers because of the high melting costs involved. To further worsen the situation, the consumer does not get back the gold in its original form but in gold only. The gold procured is melted, assayed and converted into gold bars for lending to jewellers. However, the deposit holders have an option to avail loans against Gold Deposit Certificate. With a view to make people aware about the deposit schemes, the central bank of India relaxed rules on Gold deposit schemes by allowing the lending banks to offer the scheme with shorter maturities.

6. Conclusion and Suggestions

Throughout the years, Gold has served as a hedge against inflation and the erosion of major currencies, and thus is an investment well worth considering. Indian investors due to its highest demand for gold have always made it a point to include gold in their investment portfolio to diversify the risk. The paper attempted to review the investment motives and options available in India for the same. Out of all the options available in gold-backed investment, Gold ETFs has been more popular among the Indians. However, in the SIPs option, E-gold is capturing the gold market share slowly and steadily and is expected to see an up rise yet again in future. Barring the drifts in the form of recent high import duty and other regulatory measures, gold investment is

believed to stay in India for upcoming years. However, at the same time, the rising imports should be reduced well enough to stabilize the balance of payment situation. The main reason people invest in gold is its inflation hedge property. Therefore, financial products offering real rate of return analogous to Inflation Indexed bonds may be introduced. At the same time, alternative gold-backed financial products such as gold accumulation plans or gold pension plans may be launched to reduce or postpone the gold imports. Moreover, the idle gold stocks should be monetized for productive objectives. Since Indian consumers are not yet ready to leave physical gold easily, due to their sentimental values attached, it is recommended to create awareness about gold-backed investment products.

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