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## India: Part of the fabric

By Avantika Chilkoti and James Crabtree

Can the government curb the country's insatiable appetite for gold?

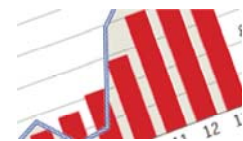


Wedding season: Models in bridal saris threaded through with gold and wearing gold jewellery at a wedding carnival in Mumbai

Amid the rush of Mumbai's chaotic international airport, customs officers beckon a passenger to step aside. A cardboard box held together by a large number of tiny staples catches their attention. Closer inspection reveals the joins are made of gold, moulded and coloured to resemble steel stationery.

It is far from an isolated incident. Border officials say gold seizures have increased dramatically in recent months. Prominent signs in main airports tell arriving passengers that gold must be declared, whether it is delicate bangles and necklaces or ingots. Still it has been found secreted in chocolate bars, television sets and even underwear. Gold cases have jumped threefold since the start of this year, according to an administrator from India's Directorate of Revenue Intelligence, an agency that covers smuggling.

### India's official gold imports



Fiscal years ending March

"We have been making seizures but there is no way you can stop it 100 per cent," says John Joseph, an official at the agency. "The trend will continue and more seizures will take place."

India absorbed about a quarter of worldwide gold supplies last year, making it the biggest gold importer. The seemingly insatiable appetite for gold is often viewed as a charming national quirk driven by elaborate weddings and lavish religious offerings. But with imports surging, ever-growing demand became one of the forces pushing Asia's third-largest economy towards financial crisis.

India increased gold duties repeatedly only for imports to hit their highest ever level in May. The influx helped to push the nation's current account gap to record levels, leaving India especially vulnerable during the capital flight that swept emerging markets this summer, dragging the rupee down more than 15 per cent.

In August the duty increases finally began to take hold, causing an import collapse and severe disruption to India's gold market, says Bhaskar Bhat, managing director of Titan, a jeweller. Shortages and price surges followed, encouraging black market operators to ship in gold that legitimate traders could no longer supply. "It comes from Dubai, from Singapore, from Bangladesh," he says. "It is hard to stop."

Now India's government faces a double dilemma. Its curbs worked, at least in the short term. But demand for gold remains strong, particularly as the country heads into its annual season of weddings and Hindu festivals. During this time, purchases soar, notably around this weekend's celebrations for Diwali, raising fears of a swift return to higher imports, and yet further pressures on external finances.

In the longer term, however, policy makers are engaged in a campaign to wean citizens off using gold to save and invest, a centuries-old obsession that many economists feel is now stifling the financial system. They hope their country's enormous gold stock – 20,000 tonnes worth a staggering \$1.1tn, according to broker CLSA – can be diverted into capital for productive investment.

“If I have one wish which the people of India can fulfil, it is don't buy gold,” P Chidambaram, the finance minister, said in June. So far his counsel is being ignored. As a result, India stands midway through its most sustained attempt yet to beat back the metal's appeal, the results of which will have consequences not just for the growth of one of the world's most important emerging economies, but the \$200bn global gold market as well.

World gold prices rose sharply following the global financial crisis as investors sought safety in haven assets. Asian buyers proved especially hungry, attracted by the metal's rising value as much as a taste for jewellery and trinkets. Indian demand jumped from 471 tonnes in 2001 to 1,017 tonnes in the year to March, worth \$54bn.

The surge put severe strain on the fragile finances of India, which has almost no domestic gold mines. The result was a jump in imports that accounted for about half of the country's current account deficit over the last financial year. Mr Chidambaram declared a crackdown in January, more than doubling import duties over six months, while the Reserve Bank of India introduced a regulation in July forcing all gold importers to re-export a fifth of what they brought in.

The latter policy had a pronounced effect. “This brought the entire industry to a standstill,” says Ashok Minawala of the All India Gems and Jewellery Trade Federation. The value of gold and silver imports fell 83 per cent year-on-year in September to \$800m.

Even so, the jewellery industry doubts whether New Delhi's emergency restrictions can be sustained. Economists say imports are set to tick up again soon even if they remain in place; India has enjoyed a good monsoon, spurring gold spending in rural areas. “Demand can't be wished away by curbing supply,” says PR Somasundaram, managing director for India at the World Gold Council, a trade body.

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That demand stems from an affinity for gold woven deeply into the fabric of India's culture – often literally, as in the case of the saris women wear on their wedding days. About half of gold purchases are tied in some way to weddings, where the metal is used for dowries.

“In our community they will definitely ask you for gold . . . otherwise they won't marry,” says Kalavati, a domestic worker from the southern state of Karnataka, who spent six times her Rs10,000 (\$163) monthly wage buying gold for her daughter's wedding, satisfying demands from her son-in-law's family.

Religion is another important factor, not least during tomorrow's festival of Dhanteras, when precious metals are used to honour Lakshmi, the goddess of wealth. Along with heaps of scented marigolds, offerings of gold jewellery and ornaments are brought to places of worship throughout the year.

Such donations have transformed India's temples into vast gold stores, with the country's three largest owning a stock of 3,500 tonnes, according to a recent report from Credit Suisse. In 2011, just one, the Sri Padmanabhaswamy temple in the southern state of Kerala, revealed a gold trove that it estimated to be worth as much as \$20bn at current market prices.

“Nowadays people are giving more. Day by day, the rush is increasing,” says Subhash Vittal Mayekar, who heads the Siddhivinayak temple in Mumbai.

These cultural and religious affinities have become more important over the past decade, causing demand for gold to increase in step with the growing affluence of India's population. Yet the nation's gold surge has as much to do with investment as piety and nuptial celebrations, especially in a country where 40 per cent of people do not yet have a bank account, says Renny Thomas, a partner at McKinsey, the consultancy, in Mumbai.

“If you are a mass-market consumer and live in a semi-urban or rural area and have some money to save, you can buy gold easily, close to where you live, and it is liquid and fairly safe,” says Mr Thomas. Loans against gold are easy to come by too – though in a nation where relinquishing family stocks carries stigma, this option tends to be used only in emergencies.

Sharply rising rural incomes have spurred gold investment further, a factor that in some instances is complemented by the metal's rising price. “If gold prices go up it doesn't deter people from buying . . . it is only an indication that it is a good investment,” says Shinjini Kumar, a director at PwC India.

More affluent savers have also poured money in, attracted by returns over the past five years that have outstripped comparable assets such as bank deposits, according to the RBI. This provides a hedge against inflation, though gold can also serve darker purposes – most notably as a repository for untaxed income, known in India as “black money”.

Ultimately it is the combination of a long-established gold culture with rising affluence that has driven India's demand surge. Yet the widespread reliance on gold assets now presents significant challenges for India's financial development, given that capital tied up in gold cannot be placed in other productive assets, such as stocks or bonds. Were Indian gold demand to fall back below 1 per cent of gross domestic product, its average in the decade before the financial crisis, an extra \$200bn of investment flows would be generated for the broader economy, according to research from Goldman Sachs.

Breaking out of the cycle will not be easy, says Eswar Prasad, an economist at the Brookings Institution, requiring the creation and successful marketing of other products. "The allure of gold is symptomatic of the weakness in India's financial system, and finding financial alternatives to it is crucial for the country's development," he says.

Raghuram Rajan, the RBI governor, says savings certificates indexed to inflation, which the central bank issued this week, can be part of the answer. The RBI has also talked up other gold-backed financial products, including gold deposit schemes, where investors earn interest by depositing personal stocks with banks, which the lenders can then recycle into the domestic market, reducing demand for imports.

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Such products raise different doubts, however. "I still find it difficult to imagine a father presenting his favourite daughter with a certificate for a gold-linked exchange traded fund on her big day," says one senior policy maker. Instead, in the longer term, ending the lust for gold is likely to mean grappling with more basic factors, such as access to bank accounts. "Curbing the demand for gold will require a lot more – a stable outlook on inflation, [new types of] savings products and controlling black money," says Shinjini Kumar.

In the short term, India may have some breathing room. Goldman Sachs, Credit Suisse and others expect global gold prices to fall over the next year. If they are correct, this could undermine its attractiveness as an investment. India's current account deficit is set to fall over the next six months, providing space for gold imports to tick up once more, and possibly for New Delhi to ease import restrictions.

But until this happens, the breadth of India's gold demand, across almost all segments of its population of 1.2bn, means pressure for fresh supplies is likely to keep growing, creating more work for officials at India's borders.

"If you focus on one thing they will stop it and invent a new thing," says Arvind Singh, who works in customs at Mumbai's international airport. Airline personnel are suspected of being involved, carrying gold and using staff passes to leave the airport without passing through customs, while middlemen are paid by sponsors to travel overseas, where they meet a dealer and bring the metal home.

Reducing such illicit imports, much like demand more generally, will take time, says Nupur Pavan Bang of the Indian School of Business.

"As long as people have money, nothing is going to stop the smuggling," she says. "They'll get it fixed in their teeth, they'll get it fixed in the sole of their shoes."

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### Markets: Tracking astrologers and weather forecasts

Commodity traders are not, for the most part, a superstitious bunch. But when it comes to the gold market, they pay close attention to the prognostications of astrologers, *writes Jack Farchy*.

The reason? Indian astrologers decide which days are auspicious for a wedding. And gold-buying during the Indian wedding season is one of the single most important drivers of the gold price.

Analysts and traders at investment banks in London, New York and Zurich also maintain close ties to the Indian weather service: the strength of the annual monsoon season determines the level of disposable income for rural Indian families, who are some of the largest buyers of gold.

"The role that India plays in the bullion markets is very prominent," says James Steel, precious metals analyst at HSBC in New York.

India has traditionally been the world's largest consumer and importer of gold, accounting for about a quarter of demand for the metal last year. Gold dealing banks such as the Bank of Nova Scotia, HSBC and JPMorgan have large networks around the country.

The country's influence in the gold market has waned somewhat in recent years, as western investment and Chinese demand have both surged, helping to push gold prices up.

As western investors lose patience with gold, however, the traditional sources of demand are once again catching the attention of traders and analysts. Since the government restrictions on imports began to take effect, the amount of gold being smuggled into India has become one of the key unknowns for the market. "It's one of the main things we're looking at," says one hedge fund manager. "It's fair to say that

the physical markets are becoming more important again as the investment markets have contracted,” says Mr Steel. “India’s prominence is moving closer to centre stage again.”

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