gold:report
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The Role of Gold in India

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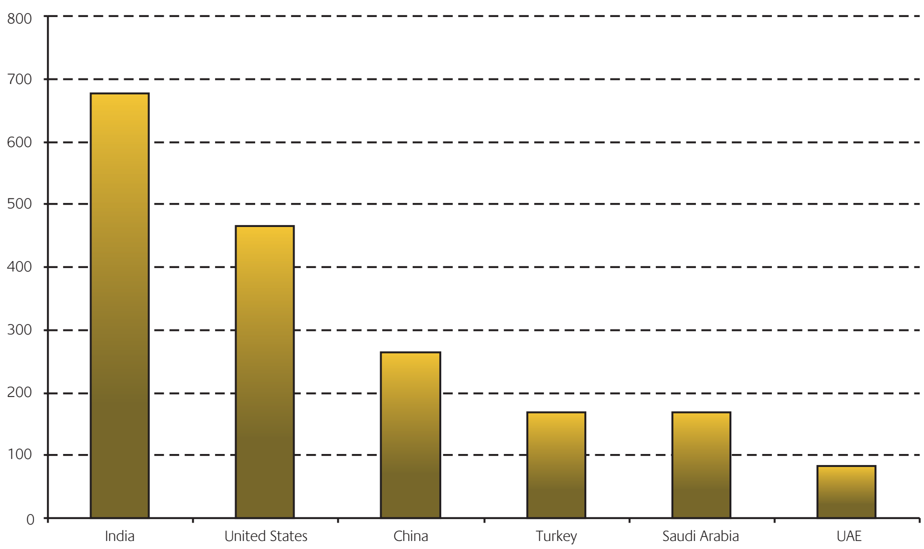
India is the world's largest gold market in volume terms, one that has expanded considerably during its period of liberalisation. This report provides a broad overview of the gold market within the context of India's new super-charged economy. It looks at all the major aspects of demand and supply, including how the jewellery sector is being affected by the current social and economic changes, new ways to invest in gold, the role of the Reserve Bank of India and on the supply-side, mine production and the scrap market.

Market size: A league of its own

India is the world's largest consumer of gold in tonnage terms. In 2005, India accounted for 22% of global gold jewellery demand and 35% of all net retail investment (coins and bars). Gold demand has grown at an average annual rate of 10% since the repeal of the Gold Control Act in 1990, which had forbidden the holding of gold in bar form[1]. Although estimates vary, India is now thought to hold close to 15,000 tonnes or 10% of the world's entire above-ground gold stocks.

Sales have averaged 676 tonnes per annum over the past decade, which is one and a half times more than in the United States, the world's second largest gold market in volume terms (it is the largest in value terms), and between three and eight times more than in China, Turkey, Saudi Arabia and the United Arab Emirates, the world's other main gold-consuming countries (Figure 1). The strength of demand over the past decade is especially impressive when juxtaposed against the price, which has risen almost continuously in rupee terms over the same period (Figure 2). Likewise in 2005, despite a 6% rise in the gold price in rupee terms, gold consumption rose to 750 tonnes from 639 tonnes the previous year, with growth in each category (jewellery, coins and bars, medallions and imitation coins, electronics and other industrial and decorative uses).

Figure 1: Annual Demand[1] for Gold (tonnes) 10 year average, 1996-2005

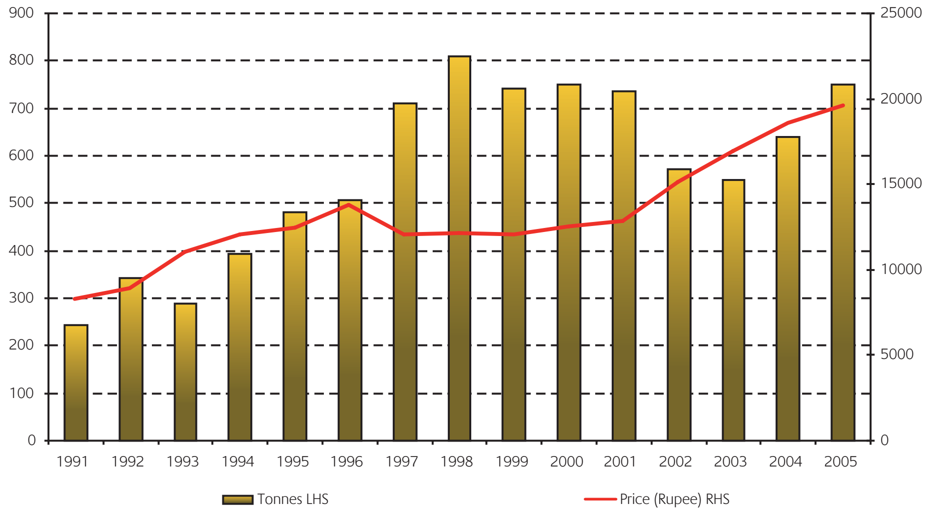


[1] Jewellery, coins and bars, medallions and imitation coins, industrial and decorartive uses

Source: GFMS Ltd.

[1] For a full discussion on the de-regulation of the Indian gold market see: *Deregulation of Gold in India*. Himadri Bhattacharya, World Gold Council, March 2003.

Figure 2: Indian Gold Demand[1] (tonnes) and Price (Rupee)



[1] Jewellery, coins and bars, medallions and imitation coins, industrial and decorartive uses

Source: GFMS Ltd., Global Insight

The origins of gold demand

Indian gold demand is firmly embedded in cultural and religious traditions. The country has one of the most deeply religious societies in the world, the most widespread faith being Hinduism, which is practiced by around 80% of the population. Gold is seen as a symbol of wealth and prosperity in the Hindu religion. The goddess Lakshmi, who symbolises fertility, productiveness and prosperity, is said to have been bathed by elephants who carried pure water in golden vessels. She is depicted as a beautiful woman of golden complexion, dressed in gold-embroidered red clothes, with gold coins flowing from her hands. Since it is suggested that those who worship her gain wealth, Hindus consider gold an auspicious metal, which they like to buy or gift during religious festivals. The most important of these is Diwali, which marks the beginning of the Hindu New Year and usually takes place in October or November.

Akshaya Thrithiya, falling in April or May, has also become an important day to buy gold. Purchases on this day are considered auspicious (it is the third most auspicious day in the Hindu calendar). The association between gold and "auspiciousness" has been used in recent years to promote the idea of buying gold. Over the past five years, Akshaya Thrithiya has become a major gold-buying occasion in the South of India, especially in the State of Tamil Nadu, where sales have reached record levels. Since 2005, the idea has been promoted across the North and West of the country, which has also resulted in a significant rise in gold sales in these regions.

Gold also plays an important role in the marriage ceremony, where brides are often adorned from head to toe in gold jewellery. Most of this will be a gift from her parents as a way of giving her some inheritance, as Hindu tradition dictates that the family's assets are only passed down to sons. The gold (and other gifts) the bride receives or her "Streedhan" ("*Stree*" meaning woman and "*dhan*" meaning wealth) mean her parents can make sure she is financially secure and enjoys at least the same standard of living to which she was accustomed in her childhood. Gold is especially important in this respect as it remains directly under her control, whereas she may not be privy to the family's other financial affairs. With an estimated 10 million marriages a year taking place in India, wedding-related demand is big business. Much of this demand takes place in the wedding season, which falls between October and January, and April and May, though a good many purchases will be made well in advance of the wedding. Indeed, it is customary for the parents of a baby girl to start accumulating gold for this purpose soon after the child is born.

Not all gold demand is allied with cultural and religious beliefs. Gold is also viewed as a secure and easily accessible savings vehicle by the rural community, where around 70% of the population lives. Gold has the added virtue of being an inflation hedge. An investor who had bought gold in 1970, for example, would have been more than protected against inflation (Figure 3). Gold is also one of the limited ways in which Indian investors can diversify their currency exposure. This is because the Rupee is not yet fully

Figure 3: Indian CPI and Gold in Rupee (re-based January 1971 = 100)

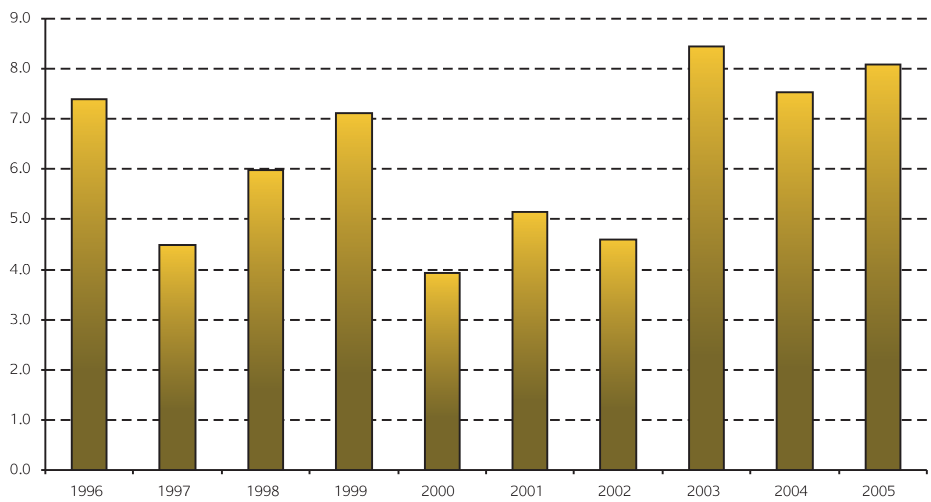
Source: Global Insight

convertible – Indians are only allowed to hold financial assets in Rupees – whereas they have been allowed to hold gold since 1990 when the Gold Control Act was repealed.

Recent economic trends

The Indian economy has enjoyed rapid growth over the past decade, thanks to the progressive liberalisation of its economy and the consequent inflow of foreign direct investment, which has allowed the economy to start reaping the benefits of globalisation on a truly massive scale. India is now the fifth largest economy in the world (on a PPP basis) having posted average annual growth rate of 6% p.a for the past decade (Figure 4). The economy shows no signs of slowing either. A noticeable feature of India's development has been the strength of its domestic economy relative to most emerging markets in Asia. This is particularly true of consumer spending, which has accounted for the lion's share of growth over the past decade. The country's $200 billion retail industry is changing, with the emergence of new large-scale retailing. Shopping centres are starting to spring up across urban India, something which is changing the face of retailing and will affect traditional gold retailers. KPMG and the Federation of Indian Chambers of Commerce and Industry estimate that the amount of shopping centre space will have risen to 90 million square feet by the end of 2007, more than four times the 22 million square feet estimated in 2005[2].

Figure 4: GDP growth (% yoy)



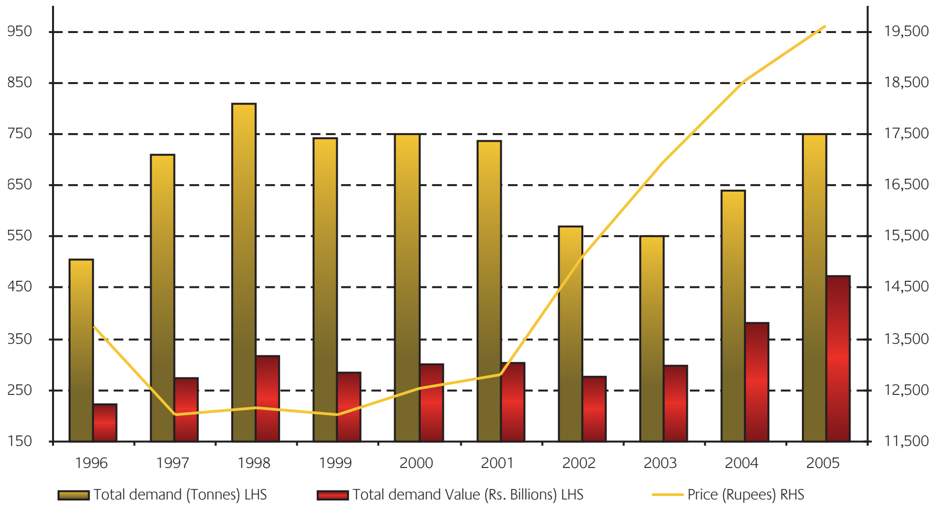
Source: Global Insight

Gold Demand Trends and Outlook

The past decade can be split into two distinct periods as far as the value of gold sales is concerned: 1996-2001, when sales were broadly stable in value terms, and 2002-2005, when sales accelerated strongly (Figure 5). During the first period, spending averaged Rs. 284 billion per annum and fluctuated in a relatively narrow range of Rs. 224-316 billion a year. Spending was especially strong in 1998 thanks to the release of pent up demand following the removal of import controls in November 1997. Gold sales were broadly stable in the three years that followed, held back by relatively weak income growth. Sales in tonnage were more volatile over the period, averaging 709 tonnes and fluctuating between 506-810 tonnes. The higher variability of *volume* as oppose to *value* spending is a function of both the retail price setting mechanism in Indian, as well as the origins of demand. The price of jewellery changes in line with changes in the international market price in India, with each

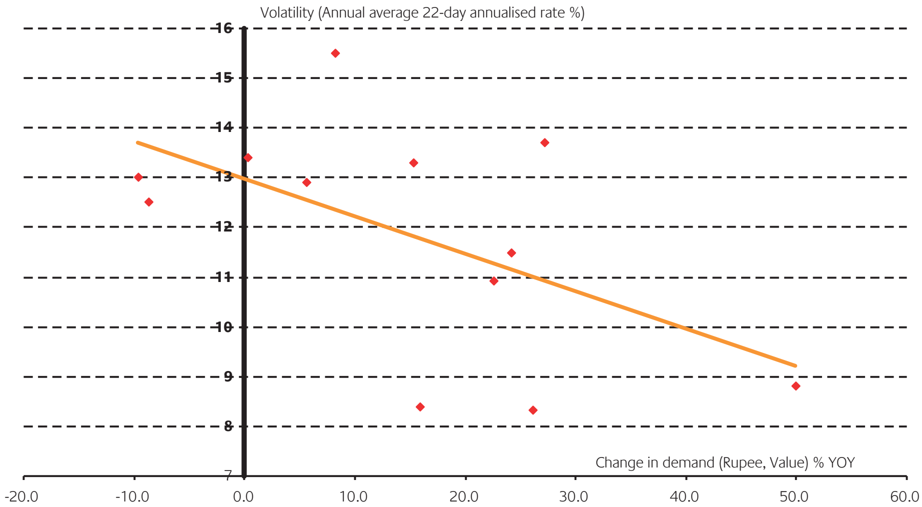
[2] *Indian retail: on the fast track,* KPMG, Federation of Indian Chambers of Commerce and Industry, December 2005.

Figure 5: Gold Demand (Volume and Value) and Gold Price (Rupees)



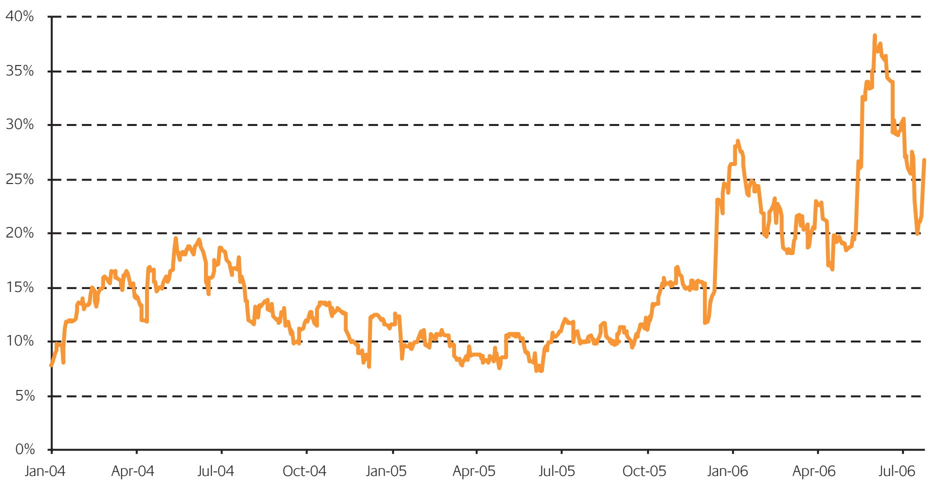
Source: GFMS Ltd., Global Insight

Figure 6: Volatility and demand (observation period 1993-2005)



Source: GFMS, Global Insight (All Calculations WGC)

Figure 7: Gold price volatility (rolling 22-day annualised rate)



Source: Global Insight (All calculations WGC)

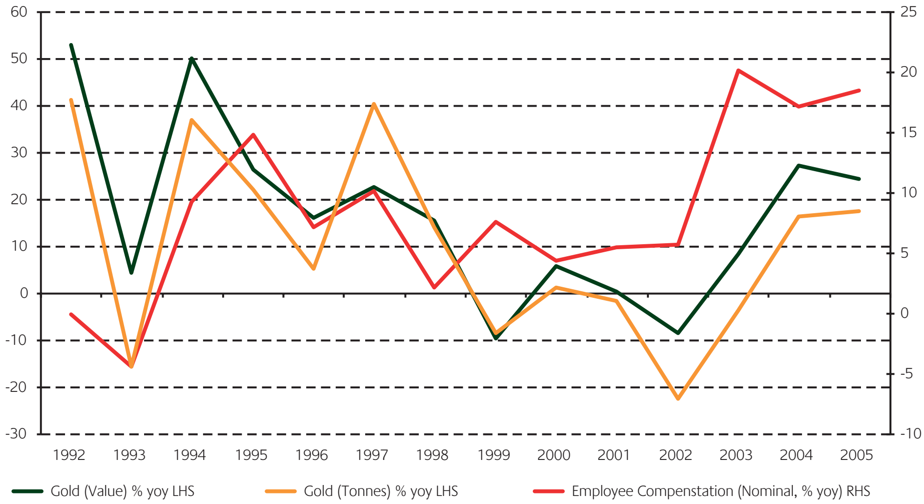
item weighed then priced according to the prevailing daily market rate. The retail mark up is also normally relatively small in relation to the value of the piece.

Still, the *value* of gold sales is often quite price inelastic, especially where gold is being used as a long-term savings vehicle. A prime example would be the parents of a baby girl saving for a future Streedhan, who will usually purchase a certain monetary *value* of gold each month, although the *volume* of gold they can afford each year will rise and fall with the price.

That Indian demand is not necessarily adversely impacted by rising prices is clear from the experience of the past few years (2002-2005), when gold demand rose steadily from Rs. 276 billion to Rs. 473 billion (or 571 tonnes to 750 tonnes) despite a coincident rise in the gold price from Rs. 15,026 to Rs. 19,599. Indeed, a rising price can often stimulate investment demand for gold, as was the case in Q1 2006, when retail investment spending surged by 32% year-on-year despite an 11% rise in the gold price in rupee terms. What does seem to adversely impact on demand is a pick up in the pace of daily price fluctuations or volatility. Consumers are wary about purchasing when the price is volatile for fear that they buy and then find the price falls. Figure 6 shows the relationship between the average annual 22-day rolling annualised volatility rate of the rupee-denominated gold price and the change in the value of gold sales: the two show a clear inverse relationship over the sample period from 1993 to 2005. The same message would seem to come from H1 2006's experience, when the value of spending fell by 7%, as gold price volatility spiked upwards (Figure 7).

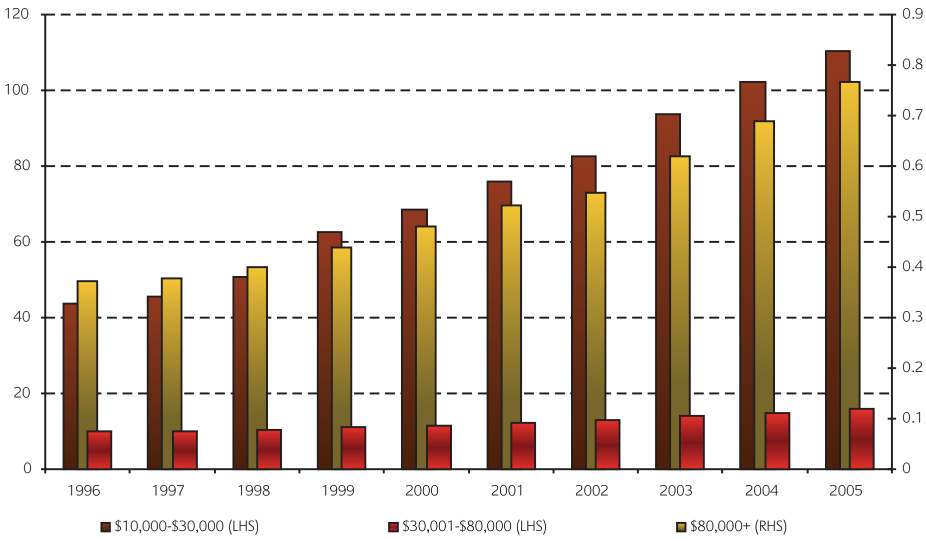
The main theme of the past few years has been a solid upswing in gold sales, with spending increasing from Rs. 276 billion in 2002 to Rs. 473 billion in 2005. This has been underpinned by social and economic changes in the Indian economy – trends that look set to persist – alongside new and better marketing campaigns from 2004 and a growing perception that higher gold prices are here to stay. Indians are enjoying a rapid acceleration in income growth, which is supporting discretionary spending on consumer goods, including gold (Figure 8). More workers are moving from low income to middle and high income quartiles, as India continues to attract large volumes of foreign direct investment, especially into the outsourcing and IT sectors. Last year, an estimated 110 million households were earning between $10-30K, 16 million between $30-80K and just short of a 1 million earning over $80K (Figure 9). Global Insight, an economic forecasting agency, expects the number of people earning between $13-30K, $30-80K and $80K+ to increase by 52%, 87% and 200% in real terms to 167 million, 30 million and 3 million respectively by 2015.

Figure 8: Employee Compensation and Gold Demand (% YOY)



Source: Global Insight

Figure 9: Number of households by income distribution (Millions, constant 1997 PPP dollars)



Source: Global Insight

Social trends are also changing. More women are seeking their independence by entering the workforce, which means there are increasingly two bread winners in the family and there is more disposable income available for discretionary purchases than in the past. Equally importantly, young middle class Indians are more willing to spend than their parents' generation was, while tastes are becoming more international, with households increasingly demanding all the conveniences of the modern world, such as mobile phones and home computers. A recent WGC study[3], conducted across six key gold markets, including India, found that the increasing independence of woman in developing countries and shifts in attitudes and behaviours, combined with a significant increase in their personal wealth, has meant that gold has become a more relevant and desirable product to a greater number of women. This has increased the number of women falling into gold's core target group in India from 25 million in 2002 to 32 million in 2005 and contributing to the rise in gold purchases over the past few years. Of course, gold must compete with a growing desire for other luxury goods too. However, as there is a much bigger pool of money available, it seems likely that the net impact of these socio-

[3] *A Passion for Gold: Realising Potential in the Gold Market*, World Gold Council, August 2006.

economic changes will be positive for gold sales, especially with the relevant marketing initiatives targeted at India's new affluent young middle class. Recent experience supports this premise, with the rise in gold sales outstripping the rise in general retail spending indices. These socio-economic changes have led to enormous growth in the potential market for gold jewellery.

Ways to buy gold

Traditionally most investment has taken the form of physical gold. In 2005, Indians bought 102 tonnes of gold coins and bars. But there are new ways to invest in gold. Since October 2003 the government has allowed futures trading and there are now three futures exchanges, the two largest being the Multi Commodity Exchange of India Ltd (MCX) and the National Commodity and Derivatives Exchange Ltd (NCDEX). The next major development is likely to be the arrival of Exchange Traded Funds (ETFs), expected before the end of 2006. UTI Asset Management Company Ltd and Benchmark Asset Management Ltd are currently seeking regulatory approval to sell a gold ETF. These instruments give investors a relatively cost efficient and secure way to access the gold market. They are listed securities that are backed by allocated gold held in a vault on behalf of investors and are intended to offer investors a means of participating in the gold bullion market without the necessity of taking physical delivery of gold, and to buy and sell that interest through the trading of a security on a regulated stock exchange.

The Reserve Bank of India

The Reserve Bank is required to hold a fixed amount of gold under the Reserve Bank of India Act. The original RBI Act (1934) obliged the Reserve Bank to hold 40% of its assets in gold coin, gold bullion and foreign securities, with not less than Rs. 400 million in value held in gold. The system was later amended, under the Reserve Bank of India Amendment Act 1956, to the minimum reserve system, that required the bank to hold at least Rs.1150 million of its assets in gold (this did not imply the need to acquire additional gold, as the value of existing gold reserves were revised up at the time). Rs. 1150 million equates to just $24.7 million at today's exchange rate and is tiny in comparison to India's total foreign exchange reserves of $151.6 billion.

India mobilised its gold reserves during the 1991 balance of payments crisis. Between May and July, India shipped a total of 47 tonnes of the country's gold reserves (the RBI is allowed to hold up to 15% of its total gold reserves outside the country) to the Bank of England as collateral against a $400 million loan and leased a further 20 tonnes of confiscated gold (not included in the reserve figures) to Union Bank of Switzerland with a six-month buyback option to raise a $200 million loan. The funds were used to help India meet its short-term debt obligations and import bill. The RBI bought back all 67 tonnes of gold later that year. It also revalued its gold reserves from Rs. 28 billion to Rs. 72 billion, as it moved from using an outdated gold price[4] to valuing its reserves at close to the international market price. The move vastly improved India's reported import coverage ratio.

The RBI currently holds 357.7 tonnes of gold, which though small in comparison to total reserves (4.4% as at September 2006), is still the fifteenth highest of central banks in tonnage terms in the world.

Supply

Mine production

There is a huge mismatch between demand and primary supply in India, the balance being made up by imports. The only major gold mine currently in production is the Hutti mine, owned by state-owned Hutti Gold Mines Company Limited, which produces around 3 tonnes of gold a year. The other major operation – the Kolar Gold Fields – closed in April 2000 having produced a total of 800 tonnes of gold. Hindustan Copper also produces some gold as a by-product, but its output is small, at just 0.2 tonnes a year. Still, there is scope for some catch up in the future, as the geological terrain of India is very similar to other major gold producing countries, like South Africa and Australia, and as the government has now opened the mining sector to foreign direct investment.

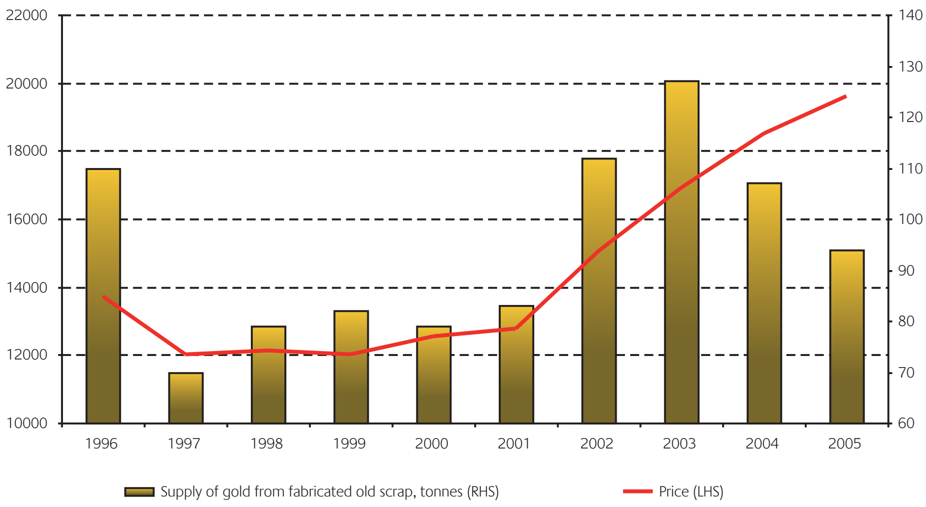
Above ground stocks

Supply from above ground stocks is much more important in India, with the main source of domestic supply coming from recycled jewellery. Over the past five years, Indians have recycled an average of 105 tonnes of gold per annum. Scrap supply is sensitive to general economic conditions, the price of gold and price expectations. The sharp increase in scrap[5] in 2002 and 2003 (Figure 10) was

[4] The RBI was valuing its gold reserves at Rs. 84.39 per 10 grammes, whereas the market price was around Rs. 2,200 per gramme.
[5] These figures do not include jewellery that is traded in for another piece.

driven by a combination of distress selling in rural areas because of the poor 2002 monsoon and subsequent hit to agricultural incomes, as well as a higher high gold price (the gold price averaged $309.68 in 2002 and $363.32 in 2003, compared with $271-$279 in the previous three years). Price expectations also matter. For instance, the decline in scrap supply in 2005, in the face of high prices and generally good economic conditions, is attributed to expectations of still higher prices[6].

Figure 10: Supply of gold from fabricated scrap (tonnes)



Source: GFMS Ltd., Global Insight

In summary, India looks poised to remain the world's foremost gold consumer in tonnage terms for many years to come. Its dynamic population growth and strong cultural and religious affinity to gold will continue to underpin structural demand. Meanwhile, rapid income growth, thanks to the influx of foreign capital, should, in tandem with new successful marketing campaigns, continue to boost discretionary spending on gold, notwithstanding temporary fluctuations associated with spikes in price volatility. India's demand will continue to be satisfied almost entirely from imports, as aside from the scrap market, very little supply comes from domestic sources.

[6] *Gold Survey 2006*, GFMS Ltd.