GOLD MONETISATION AND RUPEE INTERNATIONALIZATION

Kangan Jain [*], **Sanjeev Pandiya** [**]

jainkangan@gmail.com

ABSTRACT

The gold monetisation scheme which would replace both the present Gold Deposit and Gold Metal Loan Schemes, is a welcome initiative by the government to put into use the hitherto stashed yellow metal. It would allow the depositors of gold to earn interest in their metal accounts and the jewellers to obtain loans in their metal account. The scheme also provides sovereign gold bonds and gold coins. The GMS, if subscribed well, in addition to other macro economic variables can lead to a truly international rupee. The benefits of currency internationalization such as seigniorage, ability to finance imports in own currency-a natural hedge in cross border transactions, finance deficits and the geopolitical influence which is an "exorbitant privilege" can be achieved with successful implementation of the GMS in addition to a stable growth oriented economy and a well developed and deep financial market.

Key Words: Gold Monetisation, seigniorage, exorbitant privilege, reserve currency, currency internationalization.

INTRODUCTION:

India's obsession with gold is rivalled only by China, with the metal used widely in weddings, religious donations and as an investment asset. The country has about 20,000 tonnes of gold worth over $800 billion(Rs52.40 lakh crore) in family lockers and temples.

Previous attempts at circulating idle gold have been unsuccessful, but Prime Minister Narendra Modi's brainchild- The Gold Monetisation Scheme launched on 5th Nov'15 seems promising in terms of reducing India's reliance on the yellow metal's imports. PM Narendra Modi has recently launched three schemes- Gold Monetisation Scheme(GMS), sovereign gold bonds and the gold coin bearing the national emblem on one side and Mahatma Gandhi's image on the other aimed at pushing Indians to put thousands of tonnes of gold stacked away in households and temples into productive use and slash the metal's massive import.

GOLD MONETISATION SCHEME - WHAT AND HOW?

The new scheme would replace both the present Gold Deposit and Gold Metal Loan Schemes. It would allow the depositors of gold to earn interest in their metal accounts and the jewellers to obtain loans in their metal account. Banks/ other dealers would also be able to monetise this gold. The GMS will allow resident Indians to deposit their household gold and earn an interest of 2.25%-2.5% p.a, higher than previous rate of around 1% p.a. which is to say that your idle gold will fetch you annual returns and also free you from the security worries that physical gold entails. The earnings from the GMS would be exempt from capital gains tax, wealth tax and income tax. Under the scheme, banks will collect gold for up to 15 years to auction them off or lend to jewellers from time to time.

** Assistant Professor, Keshav Mahavidyalaya, University of Delhi*
*** President- Treasury Services, Pankti Management Consultancy(P) Ltd., Mumbai*

HOW CAN PUBLIC PARTICIPATION IN THE SCHEME BE ACHIEVED?

The GMS needs to be effectively publicized by the government by way of the PM mann ki baat programme, and as add commercials being aired at prime time slots during popular Indian programmes and news bulliten for people to know about its existence.This can be a part of the massive financial literacy programme started by the Modi government. The need of the hour is for the people of India to embrace this progressive move by the government . Definitely the objective of the government is not to question the source or hurt the emotional attachments with family gold but to bring the unproductive asset into productive use.

WHAT ARE THE BENEFITS OF THE GMS?

The benefits of the GMS canbe seen in the following points:

1. The scheme shall help the government in consolidating gold reserves and reducing gold import, helping in cutting India's burgeoning current account deficit (Rs. 1.65 lakh crores, or 1.35 of GDP) worries surrounding the yellow metal.
2. It will give a safer investment avenue to investors seeking to make money by the gold price movements through investment in the sovereign gold bonds.
3. The Indian Gold Coin would help reduce the demand for coins minted outside India, and also help to recycle the gold available in the country.
4. Also, if the Government has borrowed Gold @ 2.25%, it would be quite foolish to leave it in a vault. It would sell the Gold, effectively shorting Gold with a 'carry'. The money would save Interest Cost, bring down its Fiscal Deficit, and would be (hopefully) invested well to yield a higher tax collection. This would come from real GDP growth.

Real GDP measures the 'sweat' in the economy, which is a Behavioural Economics(BE)concept that most Classical Economists find difficult to imbibe. 'Sweat' is the potential for goods and services in a particular population and this is actually (theoretically) limitless. If there were only 2 people on a deserted island A and B, they would start a bilateral economy. Now try and imagine this, a 'thought experiment' which is also a BE concept.

Life would start with 'security needs', i.e. A looks out for the wild animals, while B looks for food. Suppose they use 1 ounce of gold to exchange with each other......and then A finds another ounce of gold in the shipwreck, which he use to get some more work out of B. Now B also gets fresh water for A, besides food. But in a little while, B has 2 ounces of gold, which A wants to get back.....and so A looks out for the wild animals AND builds a house, while B finds food AND water.

Now they are both richer. One person looks out for wild animals AND builds a house, while the other one finds food AND water. Now slowly, in this thought experiment, introduce one new person at a time, going upto 120 bn, with a wide array of skills and specialisations......you get some idea of 'potential sweat'. This sweat is harnessed by the stock of money multiplied by the velocity of money......what Gold monetisation does is to add to the stock of money, which will provide a kick to business sentiment. Begs the question how?!

Let's go back to our island. The discovery of the extra ounce of gold by A (from the ship, unknownst to B), gives a huge kick of 'relative wealth' vis-a-vis B (another BE concept). A feels like he has enslaved B with that special discovery......suppose that A has actually found a hoard of gold in the ship, and now can get B to jump through hoops with that simple discovery. Now A will go back to work only after he feels that his hoard of gold has run out.

But what has happened to the velocity of money? B is scrambling for the gold (as long as he thinks it is still precious), while A is able to produce it at will. Now suppose there were a hundred of B.....A would be having 100 slaves doing his bidding. A then goes back to work only when he runs out of his hoard of gold. The point here is ,though the stock of money goes up a little, the velocity of money goes up a lot.!!!

Inflation happens in our island when B is now too tired to do anything new for A, and B has a lot of gold, so the Marginal Utility of Gold has gone down. In Classical Economics, the Marginal

Utility of Money is held constant (BAD but simplifying assumption); but in our island, now B demands TWO ounces of gold to do anything new for A. Take it even further, and soon, B will be asking for 2 ounces of gold to do the same thing for A. That is when inflation hits!!!

In classical language, as long as there is POTENTIAL GROWTH left in the economy, the injection of REAL money will result in an increase in potential GDP and an increase in the velocity of money. In other words, new employment will go up, new goods and services will be demanded and a virtuous cycle will be created. If the Govt were to APPROPRIATE all the gold in the country (like in the US, 1935), it would kick off the same effect.

All this depends on the credibility of the Central Bank/ Government concerned. If the Government could induce people into believing that it has found 20,000 tons of gold, and 'monetise' it, it would achieve the same effect as the one recounted above. People work for the 'store of value' that a currency has, the other role of a currency besides "an exchange medium for human behaviour", which is the first role of a currency.

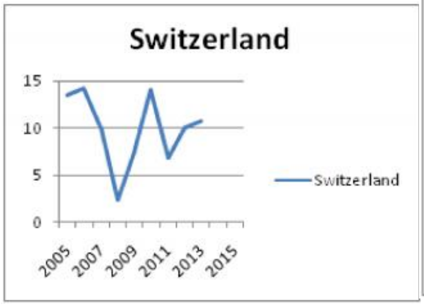
RESERVE CURRENCY

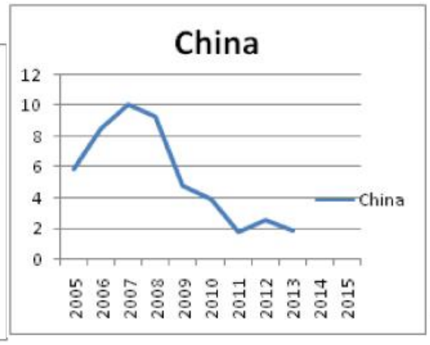
What is a Reserve Currency? Consider the Fractional Reserve (Banking wherein a (Central) Bank holds a valuable asset (maybe Gold, SDRs, etc) in 'reserve' against which it issues IOUs (called currency notes), in fractions (hence Fractional Reserve). You have the right to be 'valuable' when people think you are valuable......which means they must be confident that supply will remain limited. With Gold, people know that the supply of gold is limited and will stay so. With SDRs, people know the power to increase the supply of SDRs is in the hands of a multilateral institution (IMF) that is (not) prey to sectarian interests. A currency can be a reserve currency only when people believe that its supply will remain limited and it has a current account surplus in addition to the other enabling conditions being there - Fiscal Discipline, net savings, a big domestic market, a net debtor country, an efficient investor of international capital, home of many MNCs, low domestic tax rates, high levels of privatisation......some of which are not there even with the Dollar!!!. Hence, the current constituents of the SDR basket namely the USD, JPY, EUR, GBP, RMB may actually not be reserve currencies since their Central Banks are not closed to expanding their monetary base lets say by way of quantitative easing or currency devaluation as in case of China.

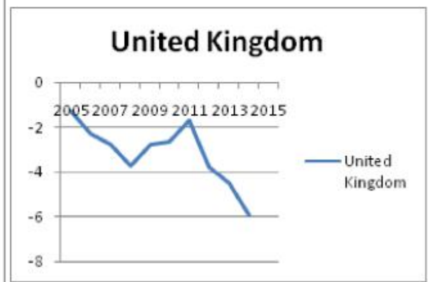
The table below shows that most of the current SDR constituents show declining current account balance trends(as % of GDP). India's CAD is declining while Switzerland's current account surplus is showing an upward trend.

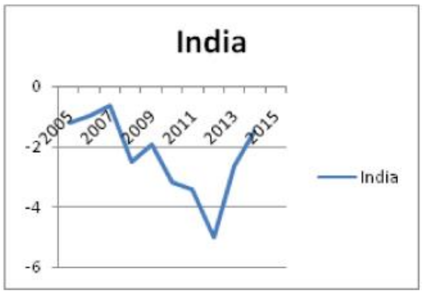
Country Name	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Switzerland	13.43766	14.21199	9.914484	2.267053	7.353976	14.02067	6.77486	9.928677	10.67248	
China	5.835243	8.493089	10.0248	9.226179	4.808002	3.937474	1.81646	2.545516	1.92619	
United Kingdom	- 1.26328	-2.26925	-2.75008	-3.70902	-2.75778	-2.61667	-1.66451	-3.74087	-4.48869	-5.9123
India	-1.23272	-0.97976	-0.65195	-2.53019	-1.9179	-3.19094	-3.40544	-4.99357	-2.644	-1.5138
Japan	3.721083	4.00925	4.860402	2.93072	2.893226	4.019518	2.194464	1.00961	0.836092	0.522024
United States	-5.6931	-5.82226	-4.9638	-4.69331	-2.66337	-2.95343	-2.96662	-2.7820	-2.2469	-2.2362

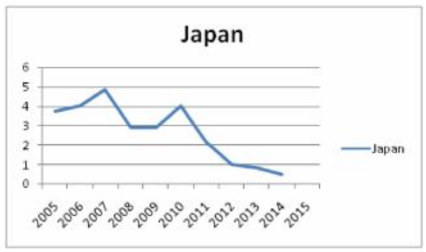
Source: http://data.worldbank.org/indicator/BN.CAB.XOKA.GD.ZS?order=wbapi_data_value_2012+wbapi_data_value&sort=asc











From this, we may say that a Reserve Currency is one in which Central Banks, inter alia, hold their assets. So does the rest of the world - banks, corporates, sovereign funds, pension funds, insurance companies, et al.

A Reserve Currency is not of the kind that gets anointed by the IMF (being included in the SDR basket), but a genuine Reserve Currency is that which is held by Central Banks in their Forex Reserves. By this definition, China is nowhere close to being a Reserve Currency yet, and is infact very far away from such a position based on the current fundamentals(in light of inclusion of the Chinese Yuan in the SDR basket on Nov.30,2015).

If you can't trust a particular Central Bank (in this case, China) to keep the supply of its currency limited (with reference to its underlying 'value'), how does it become a 'Reserve Currency' for other Central Bankers, or even the rest of the world?

On the other hand, even if some $200 bn(out of $800bn) of 'value' in the form of Gold appears in the vaults of Indian Banks, then the 'Reserve' nature of the Indian Re goes up. If the IMF does not recognise it, and uses some other specious logic of large exports, free usability, size, etc, that is their problem. The world is not going to choose the Yuan to hold Reserves in, just because the IMF says so.

The Swiss Franc is a good example. If you look at actual data, far more 'value' is held is Swiss Franc than, say, the Euro/Yen/Yuan, and that is not going to change. The Indian Re could be on its way to being a minor Reserve Currency, ahead of China. Quietly, the huge uptick in the demand for Re Corporate Bonds from the biggest creditor nation on Earth (still) is telling us that in spirit, we are not that far behind. Try selling Yuan Bonds in Japan, even though they have huge trade with China....!

To a layman the nomination by the IMF maybe the final deciding event. That, as you can see just now, is just a media event, having little significance in the real world. Who wants to 'diversify' (the language used by the IMF) to a currency that still stealthily runs on a fixed peg to the Dollar? Or a currency that is giving every indication of setting off a currency war, or competitive devaluation? Or a currency facing Capital Flight?

When we compare the Re and Yuan, we take a side that is decided by where you are on the definition itself. Being included on the SDR, yes, India is 10, no, 20 years away. But being a respectable currency where people voluntarily come to seek protection from volatility, or the depredations of Central Bankers.....that is a silent process, an improvement in reputation, that is happening even as we speak!!! In that context, the Gold Monetisation is a quiet little shift to "gold-backing" that is being done with far lower cost and much more democratically, than the Chinese process.

China seeks to gain reputation by buying 100 tons of gold every year, with Dollars from its Central Bank reserves. But it loses much of that reputation as it sails ever closer to devaluation in order to fight Capital Flight. India, on the other hand is bringing in $200-400 bn (being optimistic on the Gold Monetisation) of Monetary Stimulus, which will kick off the Investment Cycle and render the country CAD-positive on a sustainable, structural basis. This will kick off a virtuous cycle, where people from all over the world will seek out the Re as a Safe Haven currency. The world outside will look at the vast domestic Dollar Reserves, now sitting in Indian Banks at a cost of 2.25%, while Interest Rates to GOI Bonds still run at 7.75%. This benefit will be shared between the Government saving on Interest Cost, and the Banks getting a recapitalisation of their Balance Sheets, similar to the American TARP. Except that there is no increase in Money Supply, it just increases the 'sweat'(explained above) in the economy.

CONCLUSION

The gold monetisation scheme which would replace both the present Gold Deposit and Gold Metal Loan Schemes, is a welcome initiative by the government to put into use the hitherto stashed yellow metal. It would allow the depositors of gold to earn interest in their metal accounts and the jewellers to obtain loans in their metal account. The scheme also provides sovereign gold bonds and gold coins. The GMS, if subscribed well, in addition to other macro economic variables can lead to a truly international rupee. The benefits of currency internationalization such as seigniorage, ability to finance imports in own currency-a natural hedge in cross border transactions, finance deficits and the geopolitical influence which is an "exorbitant privilege" can be achieved with successful implementation of the GMS in addition to a stable growth oriented economy and a well developed and deep financial market. On the international front, INR has now begun to make a positive mark. So the GMS may help towards the utopian reserve currency status, but it may take some time to realise this dream. The GMS if absorbed well by the Indian population, even brings 10% of the idle gold into circulation , India could overcome its CAD, stabilise the INR to some extent, and cause growth domestically which if sustained(and our government policies suggest, we will), the INR could be used as reserve currency.

Though the other side of the table, the disadvantage of being a global currency also exists. With substantial currency accumulation in foreign hands, interest rates might have to be maintained high to sustain currency's exchange value. This may ultimately compromise the policy autonomy of the issuer government to avert the capricious capital flights to other nations. However, with an efficient central bank truly committed to the role of stimulating growth and managing inflation successfully, the ills of rupee internationlisation can be overcome.

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