Establishing a Spot Market for Gold

G.Mahalingam
Wholetime Member
Securities & Exchange Board of India

The recent Union Budget announcement for establishment of spot trading market in Gold is a giant step towards achieving India's objective to usher in a new ecosystem for gold in the country. Why?

Backdrop

India remains one of the largest consumers of gold in the world-second only to China. India consumes 800-900 tonnes of gold annually. Almost all of this consumption need is met out of imports as India produces minuscule quantity of gold.

There are many who look down upon gold as a commodity, as they feel that gold has been given undue importance in the world of finance. This cynicism is not entirely unfounded as gold is more an ornamental commodity and less an industrial commodity. But the stellar properties of gold like ductility, malleability and heavy density combined with the scarcity element makes it a precious asset. Even the global central banks would like to have a small chunk of its foreign exchange reserves in gold. That is because, gold is always considered a safe-haven asset and has a tendency to hold its attraction when the world of finance becomes risk-averse. From a return perspective too, if one were to look at the trend of international price of gold since the year 2000, gold has provided much better returns than many other traditional asset classes like equities, bonds and currencies.

India's unending love-story for gold

Indian population has a huge affinity for gold. The large volume of gold imports year after year has built up a vast reserve of gold (more in the form of jewelry) with the Indian households. It is estimated that such household gold will be around 25000 to 30,000 tonnes. Policymakers have made some serious attempts in the past to financialise this gold, by floating schemes to attract gold deposits in the form of physical gold (jewelry, bars, coins, etc). Once such scheme was introduced in 1999. But it came a cropper as the intending investor was quite averse to the idea of subjecting his jewelry to assaying and melting and converting it into standard gold bars, which would, in all likelihood, shatter his belief of holding on to pure gold (given the rampant unethical practices resorted to by jewelers).

The policy makers were keen on financialising gold and enticing the public to convert physical gold into financial gold as that would reduce the gold imports into the country. At present, India spends about USD 35 billion per year on gold imports. If this item of import could be reduced by even a fourth, it would put the current account of the country on a more sustainable trajectory, given the problems associated with financing current account deficit by fickle-minded capital flows.

India vis-à-vis global gold markets

Despite being a large consumer, India continues to be a price-taker in Gold and not a price-setter. The major gold markets of the world are located in New York, London, Tokyo, Dubai, etc. The prime market where the international prices of gold gets determined is London, where the London Bullion Market Association (LBMA) sets the benchmark prices of gold in two time slots during the trading day. These prices are widely used across the world. In comparison to these international markets, India has no organized and well-regulated market for spot gold trading.

While India has a fairly vibrant derivative market for gold, it is moved less by the forces of demand and supply and more by the international prices. In other words, the gold derivative market in India closely shadows the international price.

It is expected and rightly so that a spot market for gold with a deliverable option will be swayed by the underlying forces of supply and demand. In such a market, a heavy demand can push the prices up and on days, when the demand is feeble, the prices will gyrate in a narrow band. Thus, a spot gold market in India would facilitate a real demand-driven price discovery process to be established. Of course, there is a blip here. Since India does not produce gold in a big way, the supply factor will have to be driven purely by imports. Nevertheless, with a spot market in place, India with its large consumption demand, will have some decent say in determination of gold price.

SEBI's mammoth task

Establishing an exchange-based spot trading market for gold (with all its peripheral ecosystem) is a monumental project in which SEBI is presently involved in. SEBI was quick to appoint two working groups close on the heels of the Budget announcement and put out a consultation paper on the subject. This paper has elicited quite a number of comments and SEBI is now busy assimilating these comments to weave a cogent gold policy.

There are a number of issues that will confront SEBI in this mammoth task. First and foremost, should there be a single exchange for trading in gold or should there be competing exchanges for this asset class. There are pros and cons. A single exchange will help concentration of liquidity in one platform and this is certainly good for a nascent market. On the other hand, the multiple exchange concept will foster competition and innovation but may end up fragmenting liquidity. This issue therefore needs a well deliberated call to be taken by the policy makers.

Turkey and China, which have established gold exchanges have a system of ensuring that all the gold imported in the country is funneled through the exchange platform so that Gold is financialised at the very stage of entry into the Country. What should we do? Difficult question and does not have a binary answer. But, over the medium to long term (say in about 3 to 5 years), if we move over to the system of mandating all gold imports through the spot market (at least beyond a threshold level of purity), it will pave the way for financialising gold. Clearly, the Indian population has to be weaned away from physical gold as early as possible by demonstrating the advantages of financial gold.

The electronic gold receipt (EGR) outlined in the SEBI consultation paper is a powerful instrument for dematerialization of gold. But the point to be remembered here is that we need to have homogeneity and standardization of gold so as to limit the diversity of EGRs. Ideally, gold (as a traded commodity) should be refinery-agnostic and should be differentiated only on the basis of purity levels. But this is easier said than done as the mindsets and affinity associated with certain refineries cannot be easily broken.

To support a spot trading gold market with the delivery option, a tightly regulated vault ecosystem has to be put in place. This system will have to be so designed as to allow fungibility of gold as the basic tenet. If the fungibility element is not established, the market will take a long time to gain traction.

Do we allow retail segment into this market? We should, if we want, at least, over a period of time, the gold accumulated with the Indian population (estimated as 25,000 to 30,000 tonnes) to be ferreted out and financialised at least to some extent. This will require appropriate checks and controls to be built into the market design both in terms of trading lots and delivery lots.

Can banks and NBFCs play a significant role in this market ecosystem? Certainly. Banks should be willing to lend against EGRs rather than physical gold. This will require a loan policy tweak which will make the terms of gold loans attractive if it is collateralized by EGRs rather than physical gold.

The spot trading market for gold with the delivery option will become the prime market for price determination of gold. Unfettered arbitrage between spot and derivatives market will ensure that the derivatives closely track the spot price. Over a period of time, if the spot trading gains traction, gold will become an asset class in its own right even to attract retail investors, not for its ornamental qualities but for its strong investment appeal both from the angles of capital appreciation and portfolio diversification.

All in all, one hopes that this market for spot gold will fill up the long-felt gap.