De-monetization and Gold

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We are now going through the largest economic experiment in history. 1.3 billion Indians are suddenly dealing with a situation where 86% of the currency was withdrawn with a 4 hour notice; in a country where a preponderant majority of transactions are in cash. Analysts suggest that three reasons are driving this policy – checking fake currency used in terrorist financing, flushing out "black money," and bringing more people into the tax net.

In this article, we examine the implications of demonetization on the gold sector.

We are aware that over the two years to November 2016, the government had made PAN compulsory for transactions over Rs. 2 lakhs and had put a 1% excise duty on sales by jewelers.

The gold industry has always been somewhat bimodal in terms of cash transactions. At the retail end, the transactions have been primarily in cash. At the banks, bullion dealers and nominated agencies have a fairly large proportion of their transactions that are happening in non-cash means.

The immediate impact of the demonetization, of course, was a rush by people to buy gold with reportedly many jewelers having a spike in sales on the evening of November 8 and the early morning of November 9.

But what is going to be the 3 month impact and the 6 month impact and the 12 month impact? And beyond.

In the very near term, people are now scared of buying gold. In neuro-physiological terms, the amygdala has gone into overdrive and the fear of an IT raid is very prominent amongst buyers and sellers. Even legitimate buyers are postponing purchases as they wait to see further events unfolding in the demonetization scheme. Therefore, in the short term, my estimate is that official gold sales will go down. As of the writing of this article, about 11 lakh crore of the estimated 14 lakh crore of the Rs. 500 and Rs. 1000 rupee notes had been exchanged or deposited leaving another 3 lakh crores still to come in. If original estimates of the "black money" are true then we should not have much more being deposited. If it is then all the money has been laundered.

And can now be used to buy gold if required.

The key is how people evaluate the further intentions of the government. Some grapevines suggest that many stakeholders in the system that are sitting on "black money" now are getting the feeling that this drive against black money is going to continue; that this government is serious. And they are waiting to see further announcements.
On the assumption that the drive will continue in other forms (donations to political parties; GST; excise on jewelers continuing in some form in

GST), the avenues for the use of cash in buying gold will decrease. At least in the near term which would lead to a decrease in official purchases of gold in the near term.

Over a six month period, a lot will depend on the effect of demonetization on the Rabi crop. Rural demand is estimated to constitute about 40% of total demand. If the Rabi crop is adversely affected and farmers do not have surpluses to invest in gold which they have been since time immemorial, then the demand for gold from the rural sector will also take a dip.

Over a longer term (>12 months), it is possible that gold demand recovers – provided that citizens have made the transition to a lower cash transaction based gold purchases and people have, even if grudgingly, bought into the idea that they will be in the tax net. It would probably be quite important for the government to stick to the Income Tax notification of 1994 that allows 500 grams of gold for married women, 250 grams of gold for unmarried daughters and 100 grams of gold for men – without questions. Otherwise, further uncertainty in the gold policy would lead to decline in the purchase of gold over the next 12-24 month period as well.

Crucial in this area would be the tax policy on gold that is put into effect – that the government has been signaling is in the offing. A tax policy that reduces customs duty and makes the overall tax burden on the Indian buyer in sync with global prices should lead to a more predictable consumption level of gold.

In fact, if there is one thing that will influence the purchase of gold even more than de-monetization, it is the predictability and consistency of the tax policy on gold. Any business, leave alone that of gold, does not like uncertainty of policy because that makes decision making difficult and planning for the business next to impossible.

A second order effect of demonetization that would need further examination is the inventory holding capacity of retailers in the absence of cash transaction. Will the inventory turanarounds decrease from the already low levels of 2-3 a year for most jewelers? If so, there may be further reduction in gold consumption. On the other hand, if the inventory turns in the retail space increases, then we could see an increase. However, this requires a change in the behavior of consumers from buying in cash to buying through cashless means – which may not happen in the short term without consistency in purpose and action from the government in going after black money.

One effect that is quite likely is that many small gold retailers may go out of business without some fairly quick change in their modus operandi. To being able to do cashless transaction. And their ability to transition to cashless transactions may be limited not by technology – but by the inability of customers to use cashless means to buy. Education of customers may help – but only upto a point. If we take wallets like Paytm and Mobikwik, these require a smart phone and right now only about 30% of the people have smartphones. And most small buyers of gold will not, therefore, be able to buy without cash. And they may be too apprehensive to buy in cash.

The business of logistics providers and nominated agencies and banks – at least at the purchase end may not get affected much -; however, the same cannot be said with respect to the offtake of gold. So without staying power, it is likely that in the near term, these firms are also going to get negatively affected.

All in all, the key question to ask is how quickly are the various players ready and willing and able to transition to buying and selling gold on a cashless basis or on an e-transaction basis. If the answer to this question is a large majority, then the industry should be okay. Otherwise, it is in for a hard time. Necessity, they say is the mother of invention. Perhaps, the industry will judge that it is necessary to move in the direction of cashless transactions. An it will itself work to educate customers to move in that direction. In which case, we can expect a quick transition to an altogether different industry in a very short period of time.

Industries like gold normally take a decade or more to change. Demonetization may well provide the impetus to change in 1-3 years to a new look industry. The final contours of the change, however, will emerge only after we see other initiatives from the government – on customs duty, GST, e-transaction facilities and so on.

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