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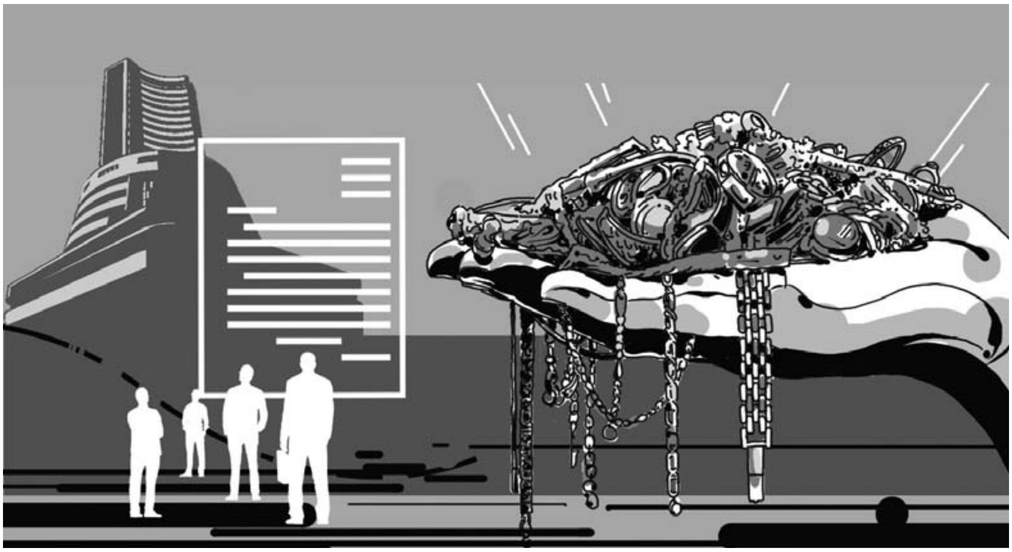

Problems of gold deposit schemes

Banks, ETFs, and jewellers can get into some arrangement, but regulation can hobble the process

In the jewellery trade, there is a mechanism by which firms obtain credit from customers. The stress in the economy and the rise in gold prices have come together to create difficulties for many jewellers. Informal arrangements that work in normal times, between people who know one another, do not scale up well into larger numbers of people and difficult times. Ready opportunities for improving the working of this market exist.

One of the less noticed business models of the country is the "gold deposit scheme". Here, an individual regularly pays money to the jeweller, and at a future date, she gets gold or jewellery.

At its best, this is a relation of trust, the regular payments are for achieving savings and a capital-raising mechanism for the jeweller. There is a legitimate role for such arrangements in an environment of high social capital. But these informal arrangements tend to scale up poorly.

SNAKES & LADDERS

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If the customer brings in money and the jeweller uses it to buy gold, this is a hedged position. But when the jeweller does not buy gold, there is gold price risk. When the price of gold goes up, unhedged jewellers will face losses. The price of gold went up from $1,200/ounce to $1,500/ounce between September last year and August this year, which has induced some stress.

When there is poor access to credit in the country, the jeweller is more likely to use these contracts as a method of capital raising. Ideally, this should be accompanied by positions on gold derivatives in order to slough off the price risk. But the state of usage of financial derivatives in India is often poor, with a host of regulatory and tax barriers.

In recent months, many stories in newspapers have appeared about crises at jewellers in these schemes. As an example, there is a story in *Mid-Day*, a local newspaper in Bombay, about one recent failure (November 1: http://bit.ly/MumJG, November 2: http://bit.ly/MumJGNov2, November 3: http://bit.ly/MumJGNov3).

The mainstream business/economics press tends to not connect the dots between such local events taking place all around the country. The *Mid-Day* stories on this firm say that pre-payment by consumers of about ₹300 crore is at stake. To the extent that this is an accurate estimate, it is not a large number, on the scale of the economy. But there are many such stories taking place: Google news searches are quite revealing. They may add up to big numbers, and each small episode casts a shadow on hundreds of families.

There is a poignant tragedy embedded in many of these stories because not all affected jewellers are crooks. Runs are irrational events that can overwhelm a sound business. Once the whispers start getting around, it is efficient for customers to ask for their money back, and when a long queue builds up, it is generally impossible to solve the situation. I am reminded of R K Narayan's book *The Financial Expert* (1952), which delves into the human dynamics of such a run.

If such relations were limited to a small circle of trust, and when two people know each other well enough to dismiss the claims going around on social media, they can still work. But when the persons in such relations do not know each other well, the relationship becomes more fragile.

Why do households take such risks — by putting their money in such savings programmes? Many elements may be at work. Formal finance in India is a centrally planned oligopoly, and works poorly from the viewpoint of its users. Financial repression forces poor rates of return upon many classes of formal financial firms. Gold is a hard currency asset that is relatively safe from expropriation.

India has a large informal economy, and the mass surveillance system that is embedded in formal finance has come to scare people, and create demand for more informal channels. A striking feature of the stories in *Mid-Day* mentioned above is that while many people are demanding their money back from the firm, only two were willing to file a complaint with the police, and these two have thus far not brought documentation to prove their claims.

When the firm fails, and it has obligations to many consumers, this is a bit like the homebuyers' problem. What is required is a smooth framework for resolution. Firm failure is part of life: What is required is a fair, swift and frictionless mechanism to resolve the firm and for everyone to move on. A key barrier here is that the state of records about these informal contracts is poor. The end-game then degenerates into power play and potentially even violence.

We can readily envision business models that address the needs of both sides. Households want to be able to save regularly and mitigate their price risk in future purchases of gold or jewellery. How can this be done better? The household can go into a systematic investment plan (SIP), through which money goes every month into gold ETF units. At a future date, the household would sell the units and pay for jewellery on the spot market.

Jewellers want to obtain working capital finance for their raw material — gold. Their working capital requirements become very large if they have to first buy gold for ₹100, work on it for a period of time, and then sell jewellery at (say) ₹120. How can this be done better? The gold ETF can lend gold to banks for a fee, which is better than the present arrangement, where this gold is idle. The banks can lend gold to the jeweller, and earn a fee. The jeweller's working capital requirement of ₹100 is eliminated. Through these contracts, everyone — consumer, jeweller, the gold ETF, and bank — is better off.

There are two constraints. Under Indian levels of central planning in finance, each leg of these business relations requires approval by a financial regulator. The users of these arrangements would be caught in the government's mass surveillance system tracking financial activities, which may not be to their liking.

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