Market Update
Indian demand will recover from 2016 lows

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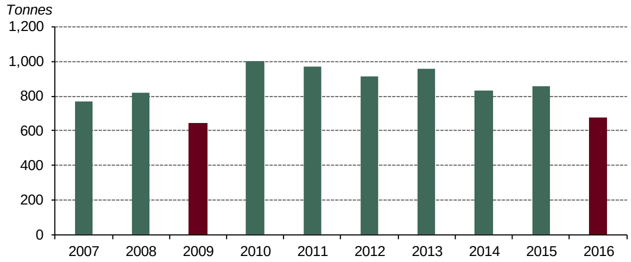
A barrage of policy initiatives, aimed at purging India of black money and instilling greater transparency, have rocked the country's economy, including its gold market. The most dramatic was the radical decision to demonetise over Rs15 trillion, equivalent to US$220bn. Other policies – such as the re-introduction of excise duty – also affected the gold market. And the forthcoming Goods & Service Tax (GST) will change the shape of the industry. It's clear that India's gold market faces short-term headwinds. But looking ahead, these policies promise to deliver a stronger and more transparent economy. This will support gold demand, which we expect to be between 650-750t in 2017.

Gold demand fell in 2016

India's gold industry suffered last year. In H1, the 1% excise duty on jewellery manufacturing prompted a 42-day strike. The income disclosure scheme disrupted the black market – fearing a backlash from tax officials, some consumers postponed buying gold. And in Q4, the shock demonetisation initiative caused a liquidity squeeze that affected the entire economy. These policies, combined with fragile rural sentiment and a soaring gold price, pushed gold demand to its lowest level since 2009[1]. (**Chart 1).**

Chart 1: Demand fell to its lowest level since 2009



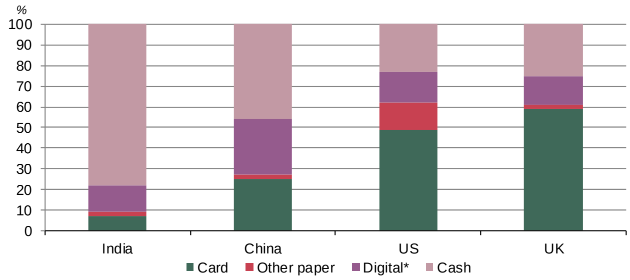
Source: Metals Focus; GFMS, Thomson Reuters; World Gold Council

[1] Please see Gold Demand Trends Full Year 2016 for more information on Indian gold demand in 2016

Transparency

Transparency is at the heart of many initiatives undertaken by India's government. The government wants to streamline its bureaucracy, clamp down on tax evasion, and move India's cash-based economy into the digital age (**Chart 2**). While this has the potential to bring many benefits, it will doubtless cause short-term disruption.

Chart 2: India is a cash-based economy



Source: Boston Consulting Group

Demonetisation: the facts

On 8th November 2016, the government announced the abolition of Rs500 and Rs1,000 notes, ordering them to be tendered into local banks or the Reserve Bank of India by 30th December. This scheme has become colloquially known in the market as demonetisation. Rs1,000 notes were scrapped entirely, but new Rs500 notes and Rs2,000 notes have since been introduced. The government also capped the value of old bills exchanged at bank counters, as well as withdrawals from bank accounts and ATMs.

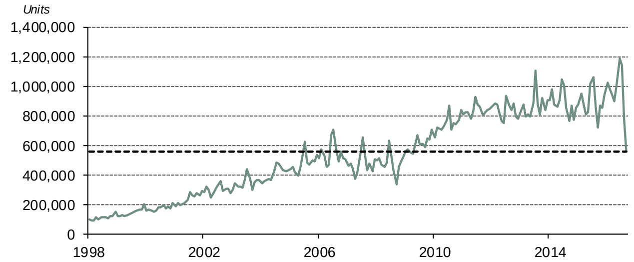
There was some flexibility. Certain payments using the old notes were allowed for a limited period: for example, purchases of petrol and airline tickets. And subsequent measures freed up cash-flow for pensioners, armed forces personnel and farmers seeking to plant crops.

Short-term liquidity squeeze

The government's objective of bringing black money into the official economy is praiseworthy, but it dented economic growth. A total of Rs15.44 trillion – or 86% of the currency in circulation – was withdrawn from the economy by the demonetisation ruling. And these notes were not replaced quickly. According to the Reserve Bank of India only Rs11.07 trillion of currency had been issued by 17th February 2017 – equivalent to just 70% of the withdrawn currency.[2]

This liquidity squeeze had a short-term impact on the economy. The informal sector – which is mainly reliant on cash – accounted for a chunky 85% of non-agricultural employment in 2012.[3] Demonetisation hit this part of the economy hard. In December, domestic sales of motorcycles – a good measure of the health of India's cash-reliant rural economy – halved in a month, falling to the lowest level in over six years **(Chart 3)**. In its recent publication, Global Economic Prospects, the World Bank noted that the liquidity shock weighed on growth in Q3 2016.[4]

Chart 3: Motorcycle sales plummeted



Source: Society of Indian Automobile Manufacturers, World Gold Council

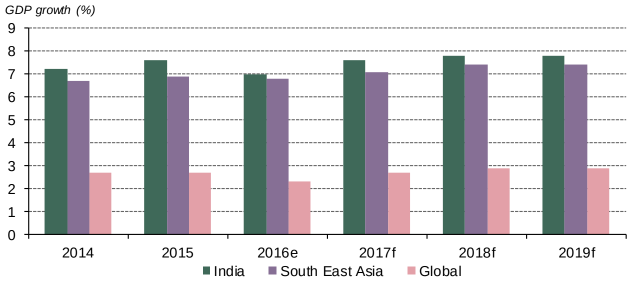
A brighter economic outlook

There are reasons to adopt an optimistic outlook for India's economy. Banks' lending ability got a lift when savers deposited their cash following demonetisation, which could boost economic growth. An inflation-busting wage hike for central government employees and pensioners will underpin consumption. And 2016's bumper agricultural crop, following the best monsoon in three years, should raise rural incomes. Rajesh Jejurikar, President and Chief Executive of Mahindra and Mahindra's Farm Equipment and Two Wheeler Division, recently said *"We see the demonetisation impact to be short-term and expect continued growth against the backdrop of improved agriculture output*."[5] His statement resonates with the recent comment from Reserve Bank Governor, Urjit Patel, who claimed that the economic recovery would be 'V' shaped.[6]

The push towards transparency will also improve India's public finances. At present, only 2% of the Indian population pays income tax.[7] As the government's policies take effect, the tax base should expand and tax revenues should increase, bolstering India's public finances.

Looking further ahead, India's economy will likely benefit from a *demographic dividend* – that is, the huge number of young people who will enter the workforce over the coming years. The World Bank thinks this will help India *"regain its momentum",* with economic growth reaching 7.8% by 2019 **(Chart 4).**[8] Such growth will support India's gold market in the years ahead – as we noted in our recent report, *India's gold market: innovation & evolution*, income growth is the primary driver of Indian gold demand.

Chart 4: India's economy will rebound



Source: World Bank

2017's Budget

That gold was not mentioned in the Budget was somewhat surprising, given the focus on the industry over recent years. But implications for the industry are significant nevertheless. From 1st April 2017, cash transactions over Rs300,000 (US$4,500) are prohibited. This will have the greatest impact in rural India, where people do not necessarily have access to cheques and electronic payments. It could curb gold purchases, it could just encourage gold shoppers to buy smaller amounts of gold spread over more transactions, or it could push a large part of demand underground and encourage growth in the black market. And while the government has made progress on GST, there is still no clarity over what rate will be implemented and whether customs duty will change to compensate for any potential increase in GST. The

[2] https://rbidocs.rbi.org.in/rdocs/Wss/PDFs/WSS170217_F1088C2B227624B26B5FC05C5F1259313.PDF

[3] http://data.worldbank.org/indicator/SL.ISV.IFRM.ZS?locations=IN&view=chart

[4] http://www.worldbank.org/en/publication/global-economic-prospects

[5] http://www.mahindra.com/news-room/press-release/Mahindra-Tractors-sells-15918-units-in-India-during-November-2016

[6] http://www.moneycontrol.com/news/economy/full-text-exclusive-moneycontrol-interviewrbi-governor-urjit-patel_8513361.html

[7] http://indiabudget.nic.in/ub2017-18/bs/bs.pdf

[8] http://www.worldbank.org/en/publication/global-economic-prospects

government will start to engage with trade and industry from 1st April 2017, at which time we might learn more.

Outlook for gold demand

After a challenging 2016, India's gold market faces headwinds. As well as the lingering effect of the policies implemented last year, the industry has more to contend with in 2017. The ban on cash transactions over Rs300,000 could hurt rural Indian demand while GST could adversely affect the industry in the short-term.

But after falling so sharply last year, demand is unlikely to fall further. Headwinds will be off-set by strong tailwinds. A banking system flush with liquidity, the bumper crop after a good monsoon, and central government employees' and pensioners' inflation-busting wage hike will all support economic growth. GST will streamline India's byzantine tax structure which, as well as boosting the economy, promises to make gold's value chain more transparent. Further ahead, the economy will benefit from the groundswell of young Indians entering the workforce – a demographic dividend similar to that which underpinned the stellar growth of the Asian Tiger economies of the 1980s and 1990s. All these factors will boost India's economic growth and support gold demand.

It is likely that the impact of demonetisation will have a behavioural impact too. The shock initiative will have tested some peoples' faith in fiat currencies and reinforced their faith in gold. We conducted a large-scale piece of consumer research in Q1 2016 in which 63% of respondents in India agreed with the statement *"I trust gold more than the currencies of countries".* And 73% of respondents in India agreed with the statement *"gold makes me feel secure for the long-term".* The demonetisation programme will underpin these beliefs.

Demonetisation is also boosting large jewellery retailers, and they will continue to grab a larger share of the market. Over time, consumers will move away from cash towards digital payments, and organised players should benefit from this trend. This change in market dynamics will result in more transparency and a better deal for consumers, protecting them from shady practices such as under-carating.

India's gold demand has fallen sharply in the past, but has then recovered. Previous attempts by the authorities to clamp down on gold have failed: gold is too intimately ingrained in Indian society.

On balance, while demand is likely to improve, our view for 2017 is cautious: we expect consumers to buy between 650t and 750t. Over time, we anticipate that economic growth and greater transparency within India's gold market will push demand higher: by 2020 we see Indian consumers buying between 850t and 950t.

About the World Gold Council

The World Gold Council is the market development organisation for the gold industry. Our purpose is to stimulate and sustain demand for gold, provide industry leadership, and be the global authority on the gold market.

We develop gold-backed solutions, services and products, based on authoritative market insight and we work with a range of partners to put our ideas into action. As a result, we create structural shifts in demand for gold across key market sectors. We provide insights into the international gold markets, helping people to understand the wealth preservation qualities of gold and its role in meeting the social and environmental needs of society.

Based in the UK, with operations in India, the Far East and the US, the World Gold Council is an association whose members comprise the world's leading gold mining companies.

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