

March 27, 2012

## India Strategy

### The Gold Attack – Is it Strong Enough?

**Quick Comment:** Through various actions starting in January, the government is expressing growing concern about the elevated levels of gold consumption (and hence imports) by Indian households. Gold represents a key source of India's macro risks and to that extent, these moves provide another reason to be bullish on equities. To be sure, the surge in gold demand over the past two years is primarily symptomatic of rising inflation expectations or negative real rates. Of course, these government moves need to be carefully calibrated, as they seem to be, because there is a very thin line between discouraging official gold imports and making gold smuggling a viable activity. So how exactly is this going to work in favor of equities? **We see three sources of benefit to equities:** 1) a smaller current account deficit, 2) more liquidity in the banking sector and 3) greater household demand for equities.

**The Gold Crush:** Gold has been a big source of stress on the current account deficit over the past two years. Indeed, ex-gold, India comes close to having a zero current account deficit (Exhibit 1). That settles worries about one of India's twin deficit woes. It also means that the country's macro vulnerability to European deleveraging and global risk appetite diminishes considerably with positive consequences for equities. Lower gold consumption will likewise relieve the pressure on domestic liquidity. Most of the stress on liquidity comes from the lack of foreign exchange reserve accretion (probably the key driver for the slowdown in reserve money growth). If gold becomes a less viable investment, it is quite likely some of that household savings comes to equities (Exhibit 2). The impact on growth is also salutary, as most other assets are far more productive than gold, again constructive for equities.

**Conclusion:** If these regulatory changes are successful in tempering gold demand, equities will benefit. Over the past two quarters, gold demand has already receded 33% YoY.

#### Government Measures on Gold

**In Jan, the import tax on gold was changed from a specific duty of Rs30/gram to a 2% *ad valorem* duty.**

**In the March budget, this was doubled to 4% for standard gold and doubled to 10% for non-standard gold.**

**Excise duty was introduced on unbranded jewelry.**

**A tax collection at source of 1% for gold/jewelry cash purchase exceeding Rs0.2m introduced.**

**Last week, the RBI introduced stricter capital requirements and LV ratios for gold lending.**

Source: Finance Ministry of India, RBI, Morgan Stanley Research

#### Interesting Gold Snippets

Household gold consumption has gone from US\$19 billion in 2009 to US\$45 billion in 2011.

Over the past 10 years, household gold consumption has increased at a CAGR of 21%.

Over the past three years, gold investments have exceeded equity savings by a factor of 11.

We estimate that the current account deficit was US\$56 billion in 2011; if we exclude household gold consumption, the CAD drops to US\$12 billion, less than 60 bps of GDP.

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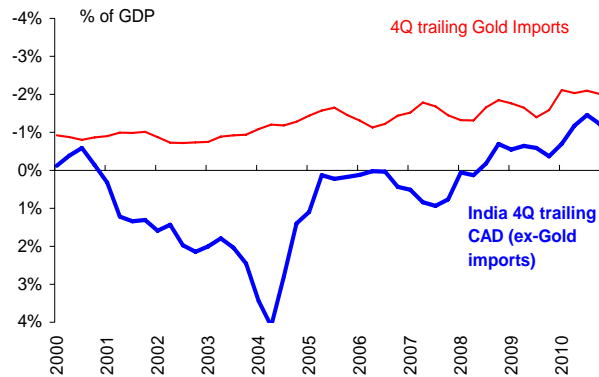
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Exhibit 1

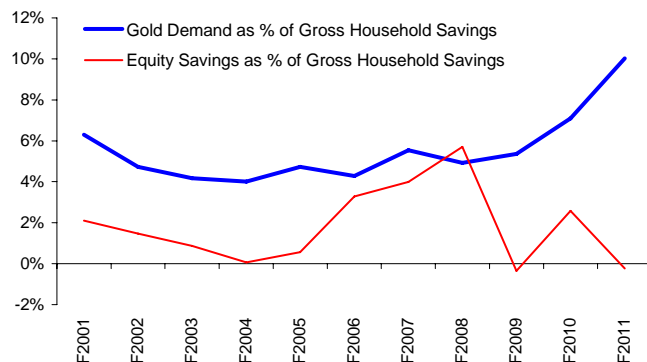
## Gold Is Driving CAD Higher



Source: CEIC, RBI, Morgan Stanley Research

Exhibit 2

## Gold Has Been Preferred Over Equities since 2008



Source: WGC, RBI, Morgan Stanley Research

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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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<b>Total</b>	<b>2,918</b>		<b>1058</b>		

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