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India's FDI Retail Policy Suspension: Set Back to Market Reforms

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After two years of deliberation the Indian cabinet announced at the end of November that it would allow foreign direct investment (FDI) into its domestic retail sector. Specifically, this proposal would have allowed 51 percent foreign investment into multi-brand retailing from outlets such as Wal-Mart and Tesco, and 100 percent FDI ownership by single-brand stores such as Apple and Nike.

Pravakar Sahoo, Associate Professor at the Institute of Economic Growth, New Delhi, and recently a South Asia Visiting Fellow at the East-West Center in Washington, explains that the Indian government's suspension of its announcement to allow foreign investment into its domestic retail market is "a blow to market reforms in India and for investors interested in the Indian economy."

This was a landmark decision which had the potential to bring critical foreign capital into a sector that is largely dominated by small and unorganized mom-and-pop—*Kirana*—stores which directly and indirectly employ around 40 million people. The announcement was good news for many international retailers including Wal-Mart, Target, Carrefour, Tesco and several Japanese retailers who had eagerly been waiting to gain greater access to the rapidly rising Indian middle class market. However, the jubilant mood and celebration of both foreign and domestic investors and millions of producers and consumers was short lived. Howls of protest within India has just led the Indian government, mere days after its initial decision, to suspend the market opening in retail.

The initial decision allowing FDI into the 51 cities with a population of more than one million residents included safeguards which mandated international retailers to source 30 percent of their total products from Indian Small and Medium Enterprises (SMEs), and 50 percent of total FDI funds to be invested in back-end infrastructure such as storage, logistics and other market related infrastructure. Furthermore, individual states would have had veto power to decide whether to allow FDI in retailing into their respective jurisdictions. This decision to allow FDI into the Indian retail sector was expected to have wide reaching implications for many different domestic stakeholders including *Kirana* retailers, along with producers, consumers, middlemen, employees, and government. In theory, if enacted, it could have transformed the way business is conducted in India, a country with a rapidly growing middle class population predicted to reach 30 percent of the population by 2030.

More importantly, the announcement was timed to send a message across the globe that India is serious about continuing economic reforms amidst an economic slowdown, as GDP growth for 2011 is now expected to be 7 percent and not the 8.5 percent forecasted earlier. The slow pace of economic reforms, combined with the European debt crisis, has resulted in investors becoming cautious about investing in India.

The FDI in retail policy would have not only brought huge foreign capital into the economy but also offered multiple benefits to producers and consumers. The scale of economies from international retail conglomerates entering the Indian market would have ensured a wider variety of products at lower cost to consumers, and ensured higher quality controls, customer guarantees and safeguards. There is empirical evidence that

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organized retailing helps stabilize prices, something that would have been welcomed by Indian consumers who have experienced average monthly inflation increases of 9 percent over the past two years.

Multinational retailers would have purchased products directly from farmers and producers, thus granting better price realization to those producers. Moreover, these organized retailers would have had to have created a steady supply chain for their products, inducing them to invest in logistics and technology for their suppliers. The provision that 50 percent of FDI be invested in back-end infrastructure such as storage, logistics and better extension services had the potential to substantially reduce wastage of agricultural produce, currently one of the highest in the world. The other provision that 30 percent of sourcing had to come from Indian SMEs was the right opportunity for these businesses to expand capacity, improve quality, and get access to international supply chains, thus making them internationally competitive over time.

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The downside was that the initial entry of overseas investment in retail was expected to have a negative impact on the unorganized *Kirana* shops as these businesses lack the financial resources to withstand the competition from international retailers in terms of variety, quality, and packaging. Empirical evidence from other developing countries shows that unorganized retailers experience slower growth upon the arrival of overseas retail chains.

This politically sensitive decision created lot of furor from opposition parties including the Bharatiya Janata Party (BJP) and the Communist Party. Furthermore, some government coalition partners came out publicly in opposition to this decision, and regional parties who support the government also opposed this development. This combination of political opposition was always going to make it difficult for the government to implement this decision. In addition, the credibility of the current United Progressive Alliance (UPA) government is under severe public scrutiny as highlighted by the recent Anna Hazare anti-corruption crusade, high headline inflation, tax evasion otherwise known as "Black Money," and policy paralysis on crucial economic reforms.

Finally the government succumbed to the overwhelming political and public pressure and announced in the first week of December that its FDI in retail policy was on hold. It is unclear how long this policy suspension will last, but it is clear that the matter will remain on the back burner at least until five state elections scheduled for 2012 are completed.

Prime Minister Manmohan Singh had emphasized that this was a well-thought-out decision reached after wide deliberations, but his government failed to convince opposition parties and coalition partners about the necessity and benefits of FDI in retailing. Overall, this is a demonstration of poor political management on behalf of the government.

What is puzzling is the timing of this FDI announcement when the government is being challenged on many different issues. Some say that the decision was taken in order to divert the attention of the opposition from other hard issues including corruption and "Black Money." The reason for announcing such a crucial policy reform measure is not only debatable but also politically sensitive. Withdrawing the policy now is a blow to market reforms in India and for investors interested in the Indian economy. This decision has created investor uncertainty and the negative results are already evident in Indian stock markets. Overall this is bad political management from the government, the repercussions of which will continue to unfold for some time yet.

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