The retail mystique and foreign investors in India

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Through a press note on 20 September, India announced that 51% foreign direct investment (FDI) in multi-brand retail trade (MBRT) has been permitted for the first time. The move was part of a round of liberalization that affects nearly all the sectors where opening up was possible in the foreseeable future.

With a fabled middle class population of up to 400 million, retail is the last bastion of India's economy (excluding agriculture). Indian governments have been trying to protect the economy from being wiped out by foreign competition ever since independence. This is a reaction to being taken over by a trading company which entered India in the 17th century and gained control over the entire trading and political scenario by the beginning of the 19th century.

This sentiment is at the core of all protectionist Indian policies for trade and agriculture over the years.

Conditions outlined

MBRT investments will be subject to certain conditions:

(1) India's states and territories will have the right to decide whether they wish MBRT to enter their region. Any government that feels MBRT would spoil the economic balance in its region is free to restrict FDI.

(2) Only cities with more than 1 million population will initially be open to MBRT.

(3) Each foreign investor will have to bring in a minimum of US$100 million in investment for a maximum 51% share of a business.

(4) At least 50% of all such FDI will have to be invested in capital expenditure on back-end infrastructure. This means the new entrant will have to invest in the supply chain, warehousing, manufacturing, logistics, etc.

(5) At least 30% of the procurement value of processed or manufactured goods should come from Indian "small industries" which have a capital outlay of less than US$1 million.

(6) Retail trade by e-commerce is not permitted.

Areas of caution

Deciphering these rules and indicators, we can identify the following areas of caution:

For the Indian economy: Various free trade agreements (FTAs) between India and its neighbouring countries could become points of infiltration for cheap foreign goods. New retailers, in their zeal to bring down prices, could misuse the FTAs to assemble and source cheap goods from reciprocating territories. This could end up undercutting Indian industries over the medium and long term.

The MBRT policy does not put any restrictions on such imports and or any limits on the imported content of products to be sold by such retail chains. In particular, India's FTAs with Pakistan and Bangladesh could become porous instruments as these countries have far-reaching FTAs with China.

Some of the large retailers that are about to enter the Indian market are global giants with extensive expertise in low-cost manufacturing areas. The policy makers should consider this.

Another concern is that restricting small industries to an investment of US$1 million in plant and machinery could deter modernization due to fear of losing the ability to sell to MBRT chains. This could lead to sweatshops with old and poor-quality machinery; badly regulated factories; and blatant violation of labour laws to ensure eligibility. So this condition could eventually be regressive in terms of investment or raising quality standards in India.

For the Indian population: Real estate could experience another round of inflationary pressure.

With severe competition, small stores that do not have the purchasing clout to get economies of scale might have to close or change their line of business.

For investors: The MBRT policy is new and is still being developed. Some changes in threshold limits and definitions are bound to come. A strong shareholders' agreement is essential, including a first right to increase shareholding, in case the policy changes.

Indian consumption and buying habits are unique. The new chains will need the ability to adapt or they will perish.

The positives

For the Indian economy: Higher FDI inflows will bring higher foreign currency reserves, higher growth rates and a stronger rupee. With more investment in the food chain as well as back-end infrastructure, efficiency, quality and reliability should rise.

For the Indian population: The new policy should bring more employment opportunities; a better value chain in food and other sectors, leading to lower prices and inflation; higher quality products at cheaper prices; and better income for farmers.

For investors: Like the US, India is a consuming market. As purchasing power rises, Indians will buy relatively more than people in other economies. The current MBRT policy will permit investors to integrate with the Indian system. Localization would bring greater gains.

If the MBRT policy is followed in the right spirit, the Indian economy and new investors could both be winners.

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