FDI in retail: Good message, bad politics?

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LSE alumnus Siddharth Ramalingam examines whether the UPA government can weather the political storm around foreign direct investment even as India's GDP growth slows down.

India's economic story over the last few years has been a painful one. Bizarre and poorly timed announcements and an inexplicable apathy towards taking necessary steps seem to have pushed India off a strong growth path. The ruling United Progressive Alliance (UPA) coalition's reform agenda, if there is one at all, has not really taken off. Recent efforts – be it the increase in fuel prices, the goods and services tax, or retrospective taxes on deals – have either been stymied by obstinate coalition partners and an unyielding opposition, or are poorly conceived. The latest announcement by the government allowing foreign direct investment (FDI) in select sectors has been widely cheered in business circles, but lambasted by opposition parties and interest groups. With elections in several states around the corner, national elections in 2014, and the pressure of coalition politics, it remains to be seen if changes in FDI rules, especially in retail, are not rescinded.

It is important to understand the context in which these 'reforms' are ensconced. There is absolutely no doubt that the Indian growth engine is slowing down. GDP growth is unlikely to exceed six per cent in the current fiscal year and growth will not realistically pick up in the next two quarters at the least. Manufacturing growth has also been poor over the last year, and the high cost of capital isn't helping. Inflation continues to be a thorn in India's side: it remains stubbornly above seven per cent and is likely to rise during the festive season between September and December. Agricultural output is expected to be below par as well, adding to inflationary expectations. The Reserve Bank of India (RBI) has, for over a year, reiterated that it is willing to trade growth away in order to control inflation. But even with inflation showing no signs of stabilising, the central bank is unlikely to drop interest rates any time soon. But then again, the role of the RBI is not just to control inflation. India's financial imbalances might prompt the bank to drop interest rates or take other monetary measures to promote growth.

Gross fiscal profligacy over the last several years has further compounded India's problems. A recent IMF study placed India third, by fiscal deficit (both central and state deficits), amongst all countries. This is extremely worrisome. The recent Kelkar Committee report urged the government to cut subsidies on petroleum, food, and fertiliser so it could get back on the patch to fiscal consolidation. The government, however, has stated clearly that 'some' recommendations made by the committee are not in line with its agenda of inclusive growth. The recent hike in the price of petrol and diesel, although moves in the right direction, are of little consequence when seen in broader context.

It should come as no surprise that the IMF has reduced India's growth forecast for the current fiscal from 6.2 per cent to 4.9 per cent. Global investors are not only worried about India's growth, but are also concerned about the government's will and ability to push through reforms. While investors will continue to invest in India irrespective of reforms, sustained and long-term investment will take place only if the right conditions for investment are created and maintained. The government's recent decision to allow FDI up to 49 per cent in aviation, up to 74 per cent in the broadcast sector, up to 51 per cent in multi-brand retail, and up to 100 per cent in single brand retail was more to signal to the international community that India was serious about allowing foreign capital into the country.

A 'secret' paper submitted by the Joint Intelligence Committee to the Union Home Ministry in 2008, highlighting threats to national security, has surfaced in the media. The paper argues that FDI from hostile countries and groups could enter sensitive sectors such as aviation and telecoms through shell companies in the Bahamas, Cayman Islands, etc. Still, there seems to be little resistance to FDI in aviation and broadcasting. What has really caused a storm in the last few weeks is FDI in retail.

Opposition parties argue that FDI in retail has been allowed without adequate safeguards for Indian traders. They argue that the Indian retail sector will ‘fold up’ and about one million people will lose their jobs. They also allege that farmers will be pressurised by large retailers to sell their produce at low prices, leading to further impoverishment. While the true impact on employment and farmer-retailer relationships can only be conjectured at this moment (but warrant consideration), there clearly are benefits from FDI in retail.

India’s retail market is massive and growth-spurring investment is expected to pour into the country. Large organised retailers are likely to invest in agricultural supply chains, something that India desperately needs as this will help reduce wastage (food wastage as a result of poor supply chains is the chief cause of agricultural product price inflation). Further, the success of FDI in retail will have an important demonstration effect on investors in other sectors in the future.

While easing FDI rules might have sent the right signal to global investors and analysts, it would be premature to think that the world has bought into the story that India is on course to do what it takes to keep its economy on a strong growth path. State elections are around the corner, and national elections are scheduled for 2014. The UPA has one last budget to pass before the country goes to polls. Given that the government’s image has been tainted by innumerable scams, it remains uncertain how its coalition partners will vote on important matters, and it feels the pressure to curry public favour before 2014, a populist budget is probably on the cards for 2013. As such, it remains to be seen if the UPA can weather the political storm over FDI. If the UPA is not voted into power in 2014, the recent changes in FDI norms may well be rescinded.

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