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U.S.-India Insight

VOLUME 6 | ISSUE 3 | APRIL 2016

The Retail Sector: Reform through Fracture

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Economic reform is not always a straightforward process in India. And no sector better epitomizes the tortured path to liberalization than India's retail trade industry. For 15 years, successive governments have attempted to make small changes, opening those parts of the retail market that seemed less politically explosive. While this was certainly welcome, it created a muddled regulatory framework, forcing potential investors into acrobatic contortions. The recent Press Note 3 of 2016, which formally allows foreign investment in marketplace-model e-commerce, highlights this complexity. And the sector may soon become even more liberal—and convoluted—when the government releases its revised foreign investment policy on marketing of food products.

The evolution of foreign direct investment (FDI) rules in retailing started back in 2000, when business-to-business e-commerce was first allowed. Since then, Indian officials have been "slicing the salami" ever thinner to explicitly allow, or ban, different variations of retail sales. Different regulatory regimes mean that potential investors must ask themselves whether they sell to businesses or consumers; one brand or multiple brands; online or offline; manufacture locally or not. Even given multiple layers of regulation, there are certainly opportunities for foreign investors. But the result is a convoluted mess. The answers to these questions could mean that an investor's model will be banned; have geographical restrictions; minimum investment limits; fall under local sourcing rules; or exist in an ambiguous space that is not explicitly covered by existing rules regulating foreign investment.

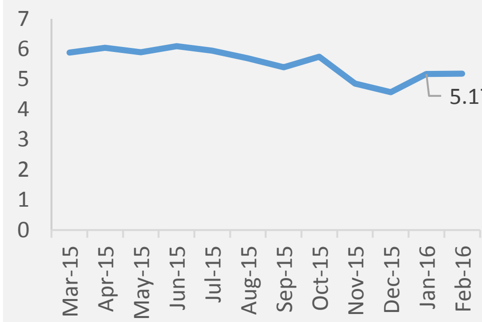
The retail sector in particular is significant for foreign investors interested in Indian markets. Employing over 33 million people and with a current compound annual growth rate of 16.7 percent, the US$600 billion retail market is expected to grow to US$1.3 trillion by 2020. Industry analysts believe the sector could realize even greater investment growth if more of the millions of informal "kirana" outlets move into the formal sector; currently 92 percent of the retail sector remains "unorganized."

During his February 29 Budget Speech to Parliament, Finance Minister Arun Jaitley confirmed that the government of India plans to open "marketing of food products produced and manufactured in India" to 100 percent FDI. Foreign investors always welcome a decision to lift market access restrictions. Yet this move will add a new level of complexity to the increasingly opaque process by which foreign companies can market products to Indian citizens. The minister for food processing industries, Harsimrat Kaul Badal, has been openly pressing for the liberalization of foreign equity rules in marketing food products. She believes allowing foreign investment in this sector will strengthen upstream investments in food processing, reducing waste in the agriculture sector.

KEY DATA

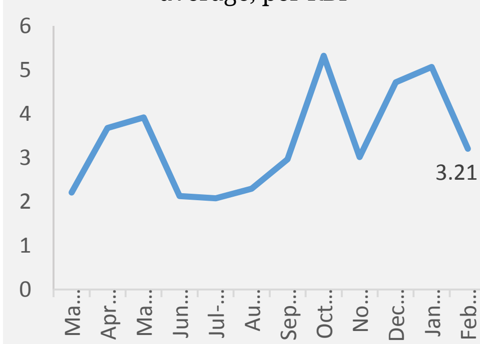
-1.3%

Increase in U.S.-India goods trade, 12-month rolling average, per U.S. Census.



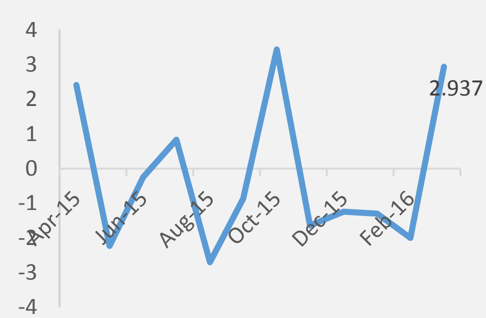
+22.7%

Increase in FDI, 12-month rolling average, per RBI



-106%

Increase in FII, 12-month rolling average, per NSDL.



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While the Bharatiya Janata Party (BJP) employed vociferous political rhetoric against foreign investment in retail as an opposition party, over the last six months the Narendra Modi government has liberalized foreign investment rules governing multiple subcomponents of the retail industry. Some examples:

- Nov 2015: Allowing 100 percent FDI in duty-free stores (previously this sector was not explicitly listed in India's list of approved sectors for FDI). Press Note 12, 2015.
- Nov 2015: Allowing a single firm to own both single brand and wholesale trading operations. Press Note 12, 2015.
- Nov 2015: Allowing single-brand retailers to sell online. Press Note 12, 2015.
- Nov 2015: Relaxing, somewhat, the rule that single-brand retailers with more than 51 percent FDI must source 30 percent of sales locally; there is now a somewhat ambiguous exception to the sourcing rule for "state of the art" or "cutting edge" products. Press Note 12, 2015.
- Nov 2015: Allowing foreign-owned companies to sell what they manufacture in India online. Press Note 12, 2015.
- March 2016: Formalizing the 100 percent FDI regime for online marketplace operators, which had been tolerated but not explicitly allowed per India's list of approved sectors for FDI. Press Note 3, 2016.

Once the Press Note is issued that formalizes the opening of "marketing of food products," a new product group will be carved out of the wider retail sector, further splintering the industry. India's long process to open the economy has generally lurched in the same positive direction for more than 20 years. But the fragmentation of foreign investment regulatory structures for different retail models has created a convoluted structure that is both confusing and fast shifting.

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