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How best to play finance SEZs

What is needed is not mere deregulation but the construction of institutions that will permit private firms to compete in exporting and inspire confidence in global customers

SNAKES & LADDERS

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The international dimension is central to Indian financial economic policy. With international financial services, there is a defensive part (of the local market losing ground) and there is an opportunity (of playing a bigger role in the world). We in India are hobbled by flaws in financial regulation, capital control, and taxation. The best path is to solve these problems for India. The second-best path is to set up finance special economic zones (SEZs). The Budget speech has achieved a big milestone in this journey.

There are two parts to the export of financial services. The defensive part worries about India's market share in the two main financial products — the Nifty and the rupee. Global customers have the full choice of taking their Nifty or rupee business to India or to other locations in the world. Our market share has dropped steadily from 100 per cent in 2007 to roughly 50 per cent today. In 2016, the Indira Gandhi Institute of Development Research (IGIDR) estimated *(https://goo.gl/8kWG3w)* that if we recaptured a dominant position in rupee trading, this would add export revenues of ₹620 billion per year. Similar large values are in play with the loss of revenues for India in the increasing migration of the Nifty business away from India.

The larger opportunity lies in looking beyond the Nifty and rupee to the full range of activities of global finance. India can play a leadership role in the world market for gold and 10 agricultural commodities. India can be the location of choice for financial activities by governments, firms, and individuals in countries like Sri Lanka, Bangladesh, or Kenya. India can compete in the global market for yen trading. Very large export revenues are feasible as few countries can match the richness of the Indian talent pool in risk-taking, accounting, law, mathematics, and computer science.

What does it take to export into global finance? Sound government and a capable high end workforce. India is in good shape on the workforce and has low state capacity in financial regulation and taxation. The Nifty and rupee trade naturally belongs in India, but our ways in capital controls, financial regulation, and tax are systematically wrong. When Jaswant Singh was finance minister, he initiated work on the question: What would it take for Bombay to compete with London? This led to the Percy Mistry report (2007). In essence, what would be required is setting up a sound financial regulatory system.

This flowed into the Financial Sector Legislative Reforms Commission (FSLRC), which was set up by Pranab Mukherjee as finance minister in 2011 and it drafted the Indian Financial Code in 2013-15. The ministry of finance also set up a Standing Committee on International Competitiveness of the Financial System, chaired by Ravi Narain. The main strategy was to fix mistakes of India's macro/finance policy, using international competitiveness as a high standard for domestic finance.

Since 2014, there is progress on some parts of the FSLRC: Inflation targeting, the merger of the Securities and Exchange Board of India (Sebi) and the Forward Markets Commission (FMC), an important amendment to the Foreign Exchange Management Act, the FSRAC appointments process, the Financial Resolution and Deposit Insurance Bill, etc. But these milestones do not suffice in achieving export competitiveness. Deep flaws in objectives, accountability, and the administrative law of financial agencies remain. Non-residents are more determined than ever to steer clear of Indian financial regulators, Indian tax policy, and the vagaries of the Indian tax administration.

As a consequence, there is no beginning on export of non-India-related financial services. It now looks like the domestic Nifty and rupee markets will be hollowed out, and the main activity will take place overseas — as has happened in other developing countries which lacked the intellectual capacity for macro/finance.

Perhaps our weak macro/finance policy capabilities will deliver the Percy Mistry/B N Srikrishna reforms in 10 to 20 years. In the meantime, we should not risk losing the Nifty and rupee markets. Perhaps we can hang on to a slice of this market share by setting up finance SEZs, where our limited macro/finance policy capabilities can deliver results sooner.

With the goods trade, SEZs like the Santacruz Electronics Export Processing Zone (SEEPZ) were important milestones. The state capacity required to set these up was low. All that had to be done was to say that India's trade barriers and tax policy would not apply in a certain geographical area. The SEEPZ gave birth to the Indian software and diamond industries. Over time, India learned how to improve tax policy and remove trade barriers. Key individuals who cut their teeth fighting for export business from the SEEPZ went on to build the Indian export industries in software and diamonds. The SEEPZ was born, it incubated ideas and human capabilities, and then faded away as those ideas took over the mainland.

Finance SEZs are more complicated than this. It is not enough to remove the Central Board of Direct Taxes, the Reserve Bank of India, and Sebi from the picture. A global customer will not trust financial services that are produced in an unregulated wild west. What is needed is not mere deregulation but the construction of FSLRC-quality institutions, which will permit private firms to compete in exporting and inspire confidence in global customers.

The Budget speech says that a new law will be enacted for a unified financial regulator for finance SEZs. Wise action at the Ministry of Finance can now be quite impactful.

The Indian Financial Code can be enacted for finance SEZs, and it can also set sound objectives for financial agencies, and sound administrative law through which those objectives are pursued.

It is not enough to pass a law: We must create high-performance organisations that will enforce the law. The Ministry of Finance needs to initiate work, ahead of time, for building organisational capabilities.

If the next steps are done right, we can get improvements in law, and the institution building of financial agencies. The steady loss of India's market share in the rupee and Nifty can be addressed. Human capabilities can be created at the Ministry of Finance, at financial agencies, in academia, and in industry, which are stepping stones for bringing reforms not just to finance SEZs but to India.

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