India’s ailing banks need more than a bailout

India has long been faced with a slow-motion bank crisis. In particular, the state-controlled institutions that dominate the sector have a bad-loan ratio that’s almost twice as bad as their private counterparts. At last count, non-performing assets made up more than 10% of banks’ advances, and were growing ever faster. Naturally, banks faced with this burden aren’t exactly eager to lend, so credit growth to the private sector has hit historic, multi-decade lows. Set against this, the central government’s plan to recapitalize the banks it owns has long been considered laughably small—just $1.5 billion was set aside in the last federal budget.

On Tuesday, the government took its first step toward fixing that problem. Finance minister Arun Jaitley announced a plan to give $32 billion to banks over the next few years. This is still only a fraction of what independent analysts estimate is necessary to restore state-owned banks to health. But it’s a start toward ensuring that the investment pipeline in India works again.

Even so, it’s far too early to celebrate. The finer print of the announcement was, frankly, disquieting. The implications for both India’s banks and its macroeconomic stability aren’t quite as positive as they might appear.

The first question is this: Will the recapitalisation leave Indian banks stronger and more sustainable? After all, this isn’t the first time they’ve needed help from taxpayers. In addition to various smaller bailouts now and then, the government put Rs20,000 crore into the banks in the early 1990s. In the years following the financial crisis, it injected another Rs58,600 crore. A system that needs constant bailing out is one that needs to be abandoned.

Yet the reason Indian public sector banks need to be bailed out so often is because they are, well, public sector. In essence, their activity—including lending—is constantly subject to political pressure. At times their “extend and pretend” behaviour is driven by the demands of what we are now supposed to euphemistically call “politically exposed persons”.

At other times, the banks are compelled to ignore their primary purpose—providing savers with returns, and supporting worthwhile projects—because of government policy. In the past few years, for example, they’ve been forced by their principal owner, the federal government, onto the front lines of other policy battles. They spent months dealing with the withdrawal and replacement of high-value currency. When they weren’t doing that, they were having to meet various inclusion targets and running camps for the prime minister’s pet projects. In other words, unless the banks are allowed to either run independently of government diktat, are privatised, or are encouraged to slowly shrink into nothingness as private competitors expand, this recapitalisation is meaningless. The banks still won’t work as they’re supposed to, and taxpayers will inevitably have to shell out money again before too long.

The second question is this: How will this recapitalisation affect the government’s balance sheet? It’s not a small amount, and how India pays for it is important. There’s not a lot of clarity about that yet. The amount of direct budgetary support is clear: It’s about a third of the total. This is, in the words of India’s chief economic adviser, “not new”, and the “residual resource mobilization” of a bailout package designed a few years ago. The remainder will be financed by “recapitalization bonds” issued by the government.

Here’s where it gets dicey. The government wants to have its cake and eat it too; it will argue that this big increase in debt does not in fact change its creditworthiness. India’s leadership is desperate for a sovereign ratings upgrade, and it has done a good job of sticking to fiscal consolidation and a transparent budget process. Yet this bailout may well destroy that process. On one hand, it will be hard to claim that you're focused on fiscal restraint when you're massively increasing public debt, as well as keeping yourself on the hook for similar calls on your purse in the future. On the other hand, if you, through sleight of hand, hide these bonds from your fiscal deficit, you're ending your commitment to transparency—and reducing your credibility as economic managers.

These are the two things to watch: Will India act to reduce government control over banks, and will it be clear and transparent about how it is spending its money? Short this knowledge, I don't think we should be particularly sanguine about how India's new bailout will turn out. **Bloomberg View**

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