Panel Remarks on

"Challenges for Monetary Policy from Debt Overhang"

Veerathai Santiprabhob

Governor of the Bank of Thailand

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First of all, I would like to thank the SNB and the IMF for the invitation and commend them for selecting a very important and relevant topic of debt overhang for this panel**. One old lesson re-learned in the global financial crisis is that high levels of debt can be dangerous.** Rises and falls in asset prices alone may not cause widespread damage unless they are accompanied by high degrees of leverage. Today's historical high debt levels are rightly a key concern for macroeconomic and financial stability. As monetary policy normalizes, the most immediate challenge is to ensure that this process is smooth and orderly.

How should we proceed? Here it is worth recalling a well-known response to a tourist seeking direction: "Well sir, if I were you, I wouldn't start from here." But given our current "starting point" of high debt, I would like to offer comments in three areas: 1) debt and monetary policy frameworks, 2) debt restructuring policy to accompany normalization, and 3) challenges related to the execution of normalization.

Let me start with the issue of debt and monetary policy frameworks.

The debt overhang that we see today should not be viewed as exogenous to monetary policy. They are part and parcel of the policy implemented over successive cycles. We need to focus not just on *flows* variables such as GDP and inflation, but increasingly and more systematically on *stock* variables that embody the cumulative impact of policy. **This implies greater consideration of the medium term effects that monetary policy has on debt and economic activity through its influence over the financial cycle.**

Here, I think that **the rhetoric of central banks, largely dictated by their frameworks, often results in central banks de-emphasizing their consideration of financial vulnerabilities.** Inflation targeting, for example, is in essence a communication framework. But if it is viewed as an inflation straitjacket through which every action must be justified, then policy can be overly restricted. **After all, inflation is only a means to an end. The ultimate goal of policy is long-run economic welfare.** When inflation is 1.5% and the target is 2%, should everything be geared towards achieving that target even if this involves, for example, higher leverage, inflated asset prices, and greater expansion of a property sector that is already overstretched?

I think these considerations are important in sustaining the trust and credibility of monetary policy in the long run. **Price stability without financial stability, as we have seen, is counter-productive to public trust of central banks. I therefore believe that our pursuit of inflation targets must be done flexibly, perhaps more so than in the past.** Paying more attention to the medium term, and the potential debt overhangs that our policy maybe supporting currently but which may constrain our policy in the future.

In this context, the role of macroprudential policy has been much discussed. A prominent view is that macroprudential tools, effectively deployed, can free up monetary policy to focus on traditional inflation and output stabilization objectives. To me, this confidence is misplaced, especially in emerging markets.

Operationalizing macroprudential policy in practice has proved challenging, partly because limited experience makes calibrating the measures difficult and partly because the interaction among different policy tools is hard to predict. By targeting particular areas, there is also a risk that these tools may push activity to corners of the financial market that do not fall under the regulatory umbrella. Finally, given its distributive nature as well as reliance on instruments that often have overlapping authorities, political economy considerations loom large. **They therefore need the support of strong institutions that not only fosters willingness and ensures ability to act, but also promotes effective cooperation across relevant agencies.** Such institutions are often missing or under-developed.

My belief is that **macroprudential tools were originally envisaged as compliments to monetary policy rather than as instruments to substitute or offset the effects of monetary or other government policies.** Their primary aim is to build resilience of the financial system, with a secondary outcome of moderating the credit cycle. This is best done early on the upswing. But at this advanced stage of the cycle with already very large debt overhangs, the scope for macroprudential policy to mitigate risks is rather limited.

Let me now turn to my second set of comments: debt restructuring policy and mechanisms to accompany normalization.

Given the unprecedentedly high level of debt we currently have, to minimize risks of unintended consequences from policy normalization, I think that we need to also focus on putting in place mechanisms that facilitate orderly deleveraging, restructure composition of debts, and minimize unintended consequences in the case that things turn sour. **Beyond economic restructuring, which tends to be for long-term and much emphasis has been placed on, we need policies and mechanisms to facilitate financial restructuring in the short and medium term.**

Parallel to the need to have macroprudential tools available during a period of excessive monetary easing, we need to have financial restructuring mechanisms available to address the problems of debt overhangs during the period of monetary policy normalization.

We need to ensure that there are mechanisms to facilitate orderly deleveraging and, in some cases, financial restructuring to address fragility in the debt structure. Different countries have debt overhang problems in different segments of their economies and in different degrees. In some countries, an emphasis should be placed on restructuring of corporate debts, especially those denominated in foreign currencies and have maturity mismatch. In other countries, an emphasis should be placed on household debt restructuring, particularly when they involve multi-creditors.

We also need to have effective and efficient debt resolution frameworks to get ourselves prepared for large-scale bad debt problems should financial market tightening results in undesirable consequences.

In such circumstances, debt restructuring and write-downs play a crucial role in restoring economic health and safeguarding long-term potential growth. For households, we don’t want bad debt to be a life sentence, creating social costs of leaving debtors in a state of perpetual debt distress. For firms, we need to preserve the entrepreneurial spirit by allowing second chances, especially among the SMEs who might not receive much benefits from monetary easing but often have to bear the burden of financial tightening. **The challenge is to strike a balance between providing debt relief and the need to preserve bank solvency, credit discipline, as well as minimize moral hazard and also take into account distributional consequences**.

While the details will differ markedly across countries, there are some common basic principles of a good resolution framework. **The overall aim is to maximize recovery rates and minimize the time and cost involved with debt restructuring, while appropriately balancing the burden shared between debtors and creditors.** This relies on at least three main elements.

The first requirement is a strong legal framework that supports effective enforcement of creditor claims while strengthening incentives to restructure. Effective insolvency laws should allocate risks among market participants in a predictable, equitable and transparent manner, as well as support the rehabilitation of viable firms and speedy liquidation of non-viable ones.

Second, the effectiveness of an insolvency law depends on an adequate institutional framework that implements the law consistently and within a reasonable timeframe. This requires an effective judicial system with competent judges, administrators, as well as private-sector insolvency practitioners.

And third, given that institutional frameworks in many countries are still weak, with overloaded court systems and lengthy and costly judicial processes, mechanisms that facilitate out-of-court workouts are also needed. These provide fast, cost effective, and market friendly alternatives to formal insolvency procedures. Several countries, including many in Europe, have introduced fast track or pre-packaged court approval procedures which provide for expeditious court approval of pre-negotiated restructuring plans that bind minority creditors.

On the whole, I think that debt restructuring and debt resolution frameworks have not adapted to match the increased prevalence of debt, both domestically and globally. Given the large increase in international corporate bond issuance, particularly from emerging markets, one area that requires attention is the framework for cross-border corporate bond restructuring. With multiple creditors located in many jurisdictions, achieving reorganization focused on preserving value rather than liquidation will be difficult. For firms with cross-border operations, the challenge is to develop a debt restructuring approach which can be effective for all of its stakeholders in all of the countries in which the company operates. **This is one area where multilateral institutions such as the IMF could usefully provide guidance based on extensive experience with international sovereign debt restructuring.**

The broader point here is that debt overhangs have a counterpart in resource overhangs. It matters what the build-up in debt is used for. Debt overhangs are often associated with sectoral misallocation of resources that not only saps productivity but are also difficult to unwind. Easy financing conditions in the boom typically favor interest-sensitive sectors, such as property and construction, while low interest rates in the recovery period may feed "zombie firms" that lock up productive capacity. **Debt overhangs, therefore, have both nominal and real dimensions** that need to be considered and tackled, and financial restructuring mechanisms are definitely needed.

Let me end by commenting on challenges related to the execution of normalization which has to do with an overhang that is close to home for many of us here. And that is the monetary overhang, by which I mean the bloated balance sheets of central banks that need to be worked off. The key challenge is how to minimize the market impact of this unwinding. Here, there is an asymmetry in how we got here and how we want to get out. **With central bank balance sheet policies, such as asset purchases and foreign exchange intervention, we want to go in with a bang but go out with a whimper. That is, we want to move markets on the entry but be market-neutral on the exit.** This is not easy to achieve and the appropriate strategy depends a lot also on the underlying asset to be unwound.

For emerging markets that have been on the receiving end of capital flows like Thailand, policy normalization in the advanced economies offers opportunities for us to unwind our large balance sheets too. Although the risks associated with a large global debt overhang means that high foreign reserves should be maintained as a buffer to absorb shocks that could arise during normalization by central banks of advanced countries. **The danger here is that the anticipated pace or scale of normalization may be subject to abrupt shifts in beliefs, leading to a sudden tightening of global financial conditions that disrupts economic activity.**

That said, these are not reasons to stop normalization. On the contrary, I think the risks to delayed normalization may be just as, if not more, serious. If policy normalization is postponed, not only would this worsen the debt overhang problem, it would also leave monetary policy with little room to maneuver in the event of a large shock or a future crisis. Over successive cycles, a kind of debt trap could emerge whereby high debt levels force policy to keep interest rates low and low interest rates keep debt levels high and the economy fragile. If we postpone normalization because of debt overhang concern, the response to a tourist seeking direction I quoted earlier will become even more relevant:

> “Sir, if I were you, I ***definitely*** would not want to start from here”

Thank you.