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Economic Inclusion and Financial Integrity—an Address to the Conference on Inclusive Capitalism

By Christine Lagarde
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As prepared for delivery

Good morning. What a great privilege to be here among such illustrious guests to discuss such an important topic.

Let me thank Lady Lynn de Rothschild and the Inclusive Capitalism Initiative for convening today's event. I would also like to recognize the great civic leaders here today—His Royal Highness, the Prince of Wales; President Clinton, and Fiona Woolf, Lord Mayor of the City of London.

We are all here to discuss "inclusive capitalism"—which must be Lynn's idea! But what does it mean? As I struggled with the answer to that, I turned to etymology and to history.

Capitalism originates from the Latin "caput", cattle heads, and refers to possessions. Capital is used in the 12^{th} century and designates the use of funds. The term "capitalism" is only used for the first time in 1854 by an Englishman, the novelist William Thackeray—and he simply meant private ownership of money.

The consecration of capitalism comes during the 19^{th} century. With the industrial revolution came Karl Marx who focused on the appropriation of the means of production—and who predicted that capitalism, in its excesses, carried the seeds of its own destruction, the accumulation of capital in the hands of a few, mostly focused on the accumulation of profits, leading to major conflicts, and cyclical crises.

So is "inclusive capitalism" an oxymoron? Or is it the response to Marx's dire prediction that will lead to capitalism's survival and regeneration—to make it truly the engine for shared prosperity?

If so, what would the attributes of inclusive capitalism be? Trust, opportunity, rewards for all within a market economy—allowing everyone's talents to flourish. Certainly, that is the vision.

Most recently, however, capitalism has been characterized by "excess"—in risk-taking, leverage, opacity, complexity, and compensation. It led to massive destruction of value. It has also been associated with high unemployment, rising social tensions, and growing political disillusion – all of this happening in the wake of the Great Recession.

One of the main casualties has been trust—in leaders, in institutions, in the free-market system itself. The most recent poll conducted by the Edelman Trust Barometer, for example, showed that less than a fifth of those surveyed believed that governments or business leaders would tell the truth on an important issue.

This is a wakeup call. Trust is the lifeblood of the modern business economy. Yet, in a world that is more networked than ever, trust is harder to earn and easier to lose. Or as the Belgians say, "la confiance part à cheval et revient à pied" ("confidence leaves on a horse and comes back on foot").

So the big question is: how can we restore and sustain trust?

First and foremost, by making sure that growth is more inclusive and that the rules of the game lead to a level playing field—favoring the many, not just the few; prizing broad participation over narrow patronage.

By making capitalism more inclusive, we make capitalism more effective, and possibly more sustainable. But if inclusive capitalism is not an oxymoron, it is not intuitive either, and it is more of a constant quest than a definitive destination.

I will talk about two dimensions of this quest—more inclusion in economic growth, and more integrity in the financial system.

Inclusion in economic growth

Let me begin with economic inclusion. One of the leading economic stories of our time is rising income inequality, and the dark shadow it casts across the global economy.

The facts are familiar. Since 1980, the richest 1 percent increased their share of income in 24 out of 26 countries for which we have data.

In the US, the share of income taken home by the top one percent more than doubled since the 1980s, returning to where it was on the eve of the Great Depression. In the UK, France, and Germany, the share of private capital in national income is now back to levels last seen almost a century ago.

The 85 richest people in the world, who could fit into a single London double-decker, control as much wealth as the poorest half of the global population– that is 3.5 billion people.

With facts like these, it is no wonder that rising inequality has risen to the top of the agenda—not only among groups normally focused on social justice, but also increasingly among politicians, central bankers, and business leaders.

Many would argue, however, that we should ultimately care about equality of opportunity, not equality of outcome. The problem is that opportunities are not equal. Money will always buy better-quality education and health care, for example. But due to current levels of inequality, too many people in too many countries have only the most basic access to these services, if at all. The evidence also shows that social mobility is more stunted in less equal societies.

Fundamentally, excessive inequality makes capitalism less inclusive. It hinders people from participating fully and developing their potential.

Disparity also brings division. The principles of solidarity and reciprocity that bind societies together are more likely to erode in excessively unequal societies. History also teaches us that democracy begins to fray at the edges once political battles separate the haves against the have-nots.

A greater concentration of wealth could—if unchecked—even undermine the principles of meritocracy and democracy. It could undermine the principle of equal rights proclaimed in the 1948 Universal Declaration of Human Rights.

Pope Francis recently put this in stark terms when he called increasing inequality "the root of social evil".

It is therefore not surprising that IMF research—which looked at 173 countries over the last 50 years—found that more unequal countries tend to have lower and less durable economic growth.

So much for the diagnosis—what can be done about it? We have done some recent work on this as well. We focused on the fiscal policy dimension—which is part of the IMF's core business. We found that, in general, fiscal policies have a good record of reducing social disparities—for example, transfers and income taxes have been able to reduce inequality by about a third, on average, among the advanced economies.

But it is a complex issue and policy choices need to be made carefully. Fiscal discipline is often the first victim on the political battlefield, and we obviously want to choose measures that do the most good and the least harm.

Some potentially beneficial options can include making income tax systems more progressive without being excessive; making greater use of property taxes; expanding access to education and health; and relying more on active labor market programs and in-work social benefits.

But we must recognize that reducing inequality is not easy. Redistributive policies always produce winners and losers. Yet if we want capitalism to do its job—enabling as many people as possible to participate and benefit from the economy—then it needs to be more inclusive. That means addressing extreme income disparity.

Integrity in the financial system

Let me now turn to the second dimension of inclusive capitalism that I have chosen to address—integrity in the financial system.

In this age of diminished trust, it is the financial sector that takes last place in opinion surveys. This might not be surprising in light of some of the behavior that triggered the global financial crisis. But it is nevertheless disturbing. As many have pointed out, the very word *credit* derives from the Latin word for trust.

We are all familiar with the factors behind the crisis—a financial sector that nearly collapsed because of excess. A sector that, like Icarus, in its hubris flew too close to the sun, and then fell back to earth—taking the global economy down with it.

We can trace the problems to the evolution of the financial sector before the crisis. Financial actors were allowed to take excessive risks, leading to a situation whereby the profits on the upside went to the industry—and the losses on the downside were picked up by the public.

Some of the greatest problems, still outstanding today, lay with the so-called too-big-to-fail firms. In the decade prior to the crisis, the balance sheets of the world's largest banks increased by two to four-fold. With rising size came rising risk—in the form of lower capital, less stable funding, greater complexity, and more trading.

This kind of capitalism was more extractive than inclusive. The size and complexity of the megabanks meant that, in some ways, they could hold policymakers to ransom. The implicit subsidy they derived from being too-big-too-fail came from their ability to borrow more cheaply than smaller banks—magnifying risk and undercutting competition.

Completing the financial reform agenda

Thankfully, the crisis has prompted a major course correction—with the understanding that the true role of the financial sector is to serve, not to rule, the economy. Its real job is to benefit people, especially by financing investment and thus helping with the creation of jobs and growth.

As Winston Churchill once remarked, "I would rather see finance less proud and industry more content".

The good news is that the international community has made progress on the reform agenda. This is especially true for banking regulation under the auspices of the Basel Committee, where we are moving forward with stronger capital and liquidity requirements. This should make the system safer, sounder, and more service oriented.

The bad news is that progress is still too slow, and the finish line is still too far off. Some of this arises from the sheer complexity of the task at hand. Yet, we must acknowledge that it also stems from fierce industry pushback, and from the fatigue that is bound to set in at this point in a long race.

A big gap is that the too-big-to-fail problem has not yet been solved. A recent study by IMF staff shows that these banks are still major sources of systemic risk. Their implicit subsidy is still going strongly—amounting to about $70 billion in the US, and up to $300 billion in the Euro Area.

So clearly, ending too-big-to-fail must be a priority. That means tougher regulation and tighter supervision.

Here, I believe that the new capital surcharges for systemic banks can work. We estimated that increasing the capital ratio on these banks by 2½ percent, beyond the Basel III standard, can reduce the systemic risk of a trillion dollar bank by a quarter. This is a big deal.

Yet the problem will not go away without steps to reduce the potential for contagion. First on the agenda should be an agreement on cross-border resolution of megabanks—providing a framework to unwind them in an orderly way in case of failure. This is a gaping hole in the financial architecture right now, and it calls for countries to put the global good of financial stability ahead of their parochial concerns.

And we should not give up just because it is hard. Let me quote John Fitzgerald Kennedy here, who famously said that "we choose to go to the moon not because it is easy, but because it is hard".

We also need more vigor across the rest of the reform agenda—better rules for nonbanks, better monitoring of shadow banks, and better safety and transparency over derivatives, an area that is still today excessively obscure and complex. To reduce the scope for contagion, I would like to see much more progress on cross-border issues, for example, in the mutual recognition of rules for derivatives markets.

Again, this is complex, and we need to be mindful of the risks of fragmenting the global financial system and hampering the flow of credit to finance investment. But complexity is not an excuse for complacency and delay.

Changing behavior and culture

As well as regulation, we need stronger supervision. Rules are only as good as their implementation. This calls for greater resources, and independence, for the supervisors who perform such a vital public duty, day in and day out.

Yet regulation and supervision by themselves are still not enough. Rules can certainly affect behavior—think of compensation practices, for example. But people who want to skirt the rules will always find creative ways of doing so.

So we also need to turn our attention to the culture of financial institutions, and to the individual behavior that lies beneath. Incentives must be aligned with expected behavior and be made transparent.

Here, the work of the FSB on Principles for Sound Compensation Practices, commissioned by the G20, is instrumental to realign incentives with actual performance. We must push on with implementation.

Why is this so important? Because the behavior of the financial sector has not changed fundamentally in a number of dimensions since the crisis. While some changes in behavior are taking place, these are not deep or broad enough. The industry still prizes short-term profit over long-term prudence, today's bonus over tomorrow's relationship.

Some prominent firms have even been mired in scandals that violate the most basic ethical norms—LIBOR and foreign exchange rigging, money laundering, illegal foreclosure.

To restore trust, we need a shift toward greater integrity and accountability. We need a stronger and systematic ethical dimension.

In grappling with this, it helps to go back to the ancient philosophers. They would have raised the most basic question—what is the social purpose of the financial sector? Or, as Aristotle would have asked: "what is its *telos*?"

He answered his own question: "Wealth is evidently not the good we are seeking; for it is merely useful and for the sake of something else". Or as Oscar Wilde put it, "the true perfection of man lies, not in what man has, but in what man is".

From this perspective, we can identify the true purpose of finance. Its goal is to put resources to productive use, to transform maturity, thereby contributing to the good of economic stability and full employment—and ultimately, to the wellbeing of people. In other words—to enrich society.

In Aristotle's framework, once we know the purpose, we can identify the virtues needed to fulfill it. It becomes a matter of every person doing the right thing.

When we think about finance, surely one of these core virtues is prudence—which is about stewardship, sustainability, and safeguarding the future. Prudence has long been a byword of banking, and yet has been sorely missing in action in recent times.

We know that regaining virtues like prudence will not happen overnight. Aristotle teaches us that virtue is molded from habit, from developing and nurturing good behavior over time. As with anything worth doing, practice makes perfect.

Getting back on the right path requires education and leadership that is sustained over many years. It requires alert watchdogs, including from civil society.

Most importantly of all, it requires investors and financial leaders taking values as seriously as valuation, culture as seriously as capital.

As Mark Carney pointed out in an admirable speech in Canada last year, the financial sector needs to be grounded in strong connections to clients and to communities—to the people served by the financial industry.

Ultimately, we need to ingrain a greater social consciousness—one that will seep into the financial world and forever change the way it does business.

The good news is that we are seeing some positive signs. The Inclusive Capitalism Initiative is one such example—pursuing practical ways to make capitalism an engine of economic opportunity for all.

We can draw some parallels here with our expanding environmental consciousness. Not so long ago, we had much higher levels of pollution, and littering was commonplace. Today, we are more educated about these issues, and more in the habit of respecting the planet.

By comparison, the equivalent kind of awareness in the financial sector—the idea that private misbehavior can have a broader social cost—is only in its early stages. It is akin to the initial period of environmental consciousness, which focused on the banning of lead from petroleum products.

Just as we have a long way to go to reduce our carbon footprint, we have an even longer way to go to reduce our "financial footprint".

Yet we must take those steps.

I realize that these are deeper questions than economists and policymakers are normally comfortable talking about. Yet I also believe the link is clear—ethical behavior is a major dimension of financial stability.

Conclusion

Let me conclude. The topic of inclusive capitalism is obviously a vast one. I could have talked about many different aspects: women's exclusion, disregard for the environment, corporate social responsibility.

Yet I wanted to focus my remarks today on the behavior that continues to deplete the treasury of trust and could again destabilize the global economy.

This is why the work of your Initiative is so important. It needs to infuse the consciousness of all economic leaders, across all sectors and countries.

At the end of the day, when the global economy is more inclusive, the gains are less elusive. The market is more effective, and a better future—for everyone—is more likely.

Thank you very much.

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Inclusive Capitalism – Genuinely Liberating or Just a Placatory Siege Response?

By George Gilligan, The University of New South Wales

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SYDNEY: 28 July - On 27 May 2014 a high profile conference took place at The Mansion House and Guildhall in London. Its theme was *Building Value and Renewing Trust* and it was organised by the Inclusive Capitalism Initiative. The panels that formed the core of the conference's activities were: '*The social responsibility of business is to increase its profits*' (a famous maxim of monetarist economist Milton Friedman); *What can businesses do to facilitate a shift to a values and purpose-led approach?*; *How labour, management and capital can work together to increase the benefits of capitalism*; *The role of innovation in boosting growth and opportunity*; *Which type of capitalism works best to build economic and social value?*; *How can corporate CEOs drive the long-term agenda?* and *How can large institutional investors and asset managers drive the long-term agenda?* These issues which are not unusual fare at business and management conferences were discussed by prominent academics, journalist, business leaders and a smattering of parliamentarians. However, unusually perhaps there were a number of extremely high profile keynote speakers including: His Royal Highness Prince Charles the Prince of Wales; Bill Clinton, the 42nd President of the United States; Christine Lagarde, Managing Director of the International Monetary Fund; and Mark Carney, Governor of the Bank of England and Chair of the Financial Stability Board (FSB). Also the amalgam of hosts and organisers included some financial sector *heavy hitters*: the City of London; E.L. Rothschild; the Inclusive Capitalism Initiative; the Financial Times; and Edelman. So, what is inclusive capitalism? What is its significance, if any? And will the 27 May conference have any substantial legacy effects?

In her speech to the conference, Christine Lagarde considered the historical origins of the term capitalism itself: 'Capitalism originates from the Latin "caput", cattle heads, and refers to possessions. Capital is used in the 12th century and designates the use of funds. The term "capitalism" is only used for the first time in 1854 by an Englishman, the novelist William Thackeray—and he simply meant private ownership of money.' Mark Carney noted in his speech to the 27 May conference that: 'Inclusive capitalism is fundamentally about delivering a basic social contract comprised of relative equality of outcomes; equality of opportunity; and fairness across generations. Different societies will place different weights on these elements but few would omit any of them.'

So equality, fairness and a sense of social contract seem to be structural features of inclusive capitalism but to date a universally accepted definition of the term does not seem to have emerged. The ubiquitous Wikipedia states that: 'inclusive capitalism is a term composed of

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two complementary meanings: (1) poverty is a significant, systemic problem in countries which have already embraced or are transitioning towards capitalistic economies, and (2) companies and non-governmental organizations can sell goods and services to low-income people, which may lead to targeted poverty alleviation strategies, including improving people's nutrition, health care, education, employment and environment, but not their political power'. This last point about inclusive capitalism being a strategy for incrementally increasing the material wealth of the mass of consumers, without necessarily empowering them, is an issue which fanned criticism, indeed ridicule, of the 27 May conference in some quarters, and it is discussed in more detail below. The term inclusive capitalism itself, appears to have been first been used in 2005 by University of Michigan Professor of Business, C.K. Prahalad, when he discussed the potential for eradicating poverty through business profit making.

What has really propelled the high media profile of the inclusive capitalism concept in recent years has been its adoption since 2011 by the Henry Jackson Society, a conservative think tank established in Cambridge UK in 2005 and named after US Senator Henry M. Jackson, who represented the State of Washington from 1953-1983. The Henry Jackson Initiative for Inclusive Capitalism developed into the Task Force for Inclusive Capitalism and in May 2012 it published *Towards a More Inclusive Capitalism*. Following its publication later in 2012, The Inclusive Capitalism Initiative was established: '..as the legacy vehicle of the Task Force for Inclusive Capitalism'. The Inclusive Capitalism Initiative describes itself as: '..a non-profit organisation that seeks practical ways to renew capitalism to make it an engine of economic opportunity and shared prosperity through the adoption of inclusive business practices… and *Towards a More Inclusive Capitalism* the founding blueprint for the Initiative'.

The opening sentence of *Towards a More Inclusive Capitalism* describes capitalism as 'very much under siege' and so sets out what it terms 'the case for capitalism'. The study argues that: '…capitalism has made the world healthier, richer and freer than previous generations could have imagined…At the same time, we recognize the serious dislocations caused by developments in the capitalism of the last 30 years—developments exacerbated by the recent crisis: Several million manufacturing jobs have moved to developing countries where labor is cheaper…Youth unemployment is unacceptably high…- Income inequality has radically increased over the last 30 years in the U.S. and the U.K. Market pressure and compensation structures led managements to focus more sharply on short-term profits than on the long-term requirements of their businesses.'

It remains a moot point despite the efforts of protest movements in many countries such as *Occupy Wall Street*, *Occupy Berlin* or *Occupy Sydney* as to just how much capitalism is *under siege*, although there is deep widespread popular resentment in many countries towards the finance sector in general and bankers in particular, rather than capitalism per se. Regardless, those who wrote *Towards a More Inclusive Capitalism* certainly feel under siege and state that: 'The three crucial areas we have identified in which companies and institutions can make, and are making, positive progress are (a) education for employment, (b) support for small and medium-sized enterprises (SMEs), and (c) improvements in corporate management and governance for the long term…. We believe large companies can help SMEs without making any significant compromises to their own profitability. For this to happen, however, they must mentor SMEs in working more successfully as suppliers to large companies. Today's focus on short-term performance must be replaced by long-term thinking on everybody's part. Companies need not offer quarterly earnings guidance. They should seek ways to reward investors who hold their shares for the long term.'

The warnings about short-termism are echoed in many quarters but again there is a sense of sustaining the status quo and power issues in the quote above such as '…must mentor SMEs in working more successfully as suppliers to large companies.' Co-host of the conference was Lady Lynn Forester de Rothschild, wife of Sir Evelyn de Robert Rothschild, member of the famous Rothschild banking dynasty that is one of the wealthiest families in the world. For better or worse it is the involvement of Lady de Rothschild that in part has prompted scorn about the 27 May conference from some commentators. For example Pam Martens in a piece entitled: *Try to Contain Your Laughter: Prince Charles and Lady de Rothschild Team Up to Talk About 'Inclusive Capitalism'*: 'The lurking undertone of the conference was not so much a noblesse oblige gesture to spread the wealth as it was an effort to address the growing anxiety among the well-heeled that if they don't step up their PR game, government and/or a populist revolution is going to take the reins – and possibly their heads.'

Similarly Ahmed who views The Inclusive Capitalism Initiative as a Trojan Horse to quell what he sees as a potential global revolt against the established orders of capitalism: 'Central to the proceedings was an undercurrent of elite fear that the increasing disenfranchisement of the vast majority of the planetary population under decades of capitalist business-as-usual could well be its own undoing.' Martens and Ahmed may or

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may not be correct in their suspicions about The Inclusive Capitalism Initiative. Certainly Lady Forester de Rothschild is worried, stating in an interview with Bloomberg prior to the conference that inclusive capitalism no longer exists, has become 'an oxymoron' and that: 'It is really dangerous when business is viewed as one of society's problems.'

Some of Lady de Rothschild's concerns were echoed at the conference by Christine Lagarde, Managing Director of the International Monetary Fund: 'The 85 richest people in the world, who could fit into a single London double-decker, control as much wealth as the poorest half of the global population– that is 3.5 billion people….In the decade prior to the crisis, the balance sheets of the world's largest banks increased by two to four-fold…. This kind of capitalism was more extractive than inclusive.' As Ms Lagarde notes one of the major casualties of this type of extractive capitalism has been community trust in both business and political leaders and she cites the findings of the 2014 poll undertaken by the Edelman Trust Barometer: '..less than a fifth of those surveyed believed that governments or business leaders would tell the truth on an important issue…This is a wakeup call. Trust is the lifeblood of the modern business economy. Yet, in a world that is more networked than ever, trust is harder to earn and easier to lose….In this age of diminished trust, it is the financial sector that takes last place in opinion surveys. ..As many have pointed out, the very word *credit* derives from the Latin word for trust. We are all familiar with the factors behind the crisis—a financial sector that nearly collapsed because of excess. A sector that, like Icarus, in its hubris flew too close to the sun, and then fell back to earth—taking the global economy down with it.'

As Ms Lagarde eloquently observes, it is gross inequalities of wealth distribution, compounded as seen in the global financial crisis by excessive risk-taking, abdication of moral hazard and short-termism within the financial sector in particular, that can cause a systemic loss of trust in the broader structures and processes of capitalism. These are the threats that prompted the Inclusive Capitalism Initiative conference. Ms Lagarde's views found support with one of the world's most influential financial regulators, Mark Carney, Governor of the Bank of England and Chairman of the G20's Financial Stability Board. In his speech to the 27 May conference Mr Carney discussed the problems associated with the growing exclusivity of capitalism, the need for financial reform and the rebuilding of social capital, allied with a building of a sense of vocation and responsibility in business. Such initiatives were necessary in order to ensure dynamic sustainable markets, long-term perspectives, fairness, the generation of trust and an engaged citizenry. Mr Carney freely admitted that his: '..core point is that, just as any revolution eats its children, unchecked market fundamentalism can devour the social capital essential for the long-term dynamism of capitalism itself. To counteract this tendency, individuals and their firms must have a sense of their responsibilities for the broader system.'

Mr Carney's comments reflect a similar view expressed by my colleagues Justin O'Brien, Seumas Miller and myself when writing about embedding restraint with stability in the regulation of the finance sector. Sustainable systemic stability requires integrating increased levels of professionalism with notions that the privilege of participation as a business actor carries with it obligation to the broader community and that this: '…should not be viewed as an impossible challenge because for all organisations there should be a rational symbiosis between sensible commercial strategies, notions of individual and corporate ethical responsibility, and statutory legal obligations.' If one sets aside conspiratorial evaluations of inclusive capitalism about whether it may or may not be a placatory siege response, this in essence is its promise. It presents as an opportunity for business interests (including the finance sector) and the communities from which they derive their profits to rebuild the social contract between them through a rebalancing of privilege and obligation on more sustainable pathways.

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