INTERNATIONAL MONETARY FUND

CHRISTINE LAGARDE

Economic Inclusion and Financial Integrity

Address to the Conference on Inclusive Capitalism
London • May 27, 2014

I N T E R N A T I O N A L   M O N E T A R Y   F U N D

CHRISTINE LAGARDE

Economic Inclusion and Financial Integrity

Address to the Conference on Inclusive Capitalism
London • May 27, 2014

International Monetary Fund Managing Director Christine Lagarde delivered this address, "Economic Inclusion and Financial Integrity," to the Conference on Inclusive Capitalism in London on May 27, 2014.

ISBN: 978-1-51358718-9 (paper)
978-1-51351375-1 (Web PDF)

Please send orders to:
International Monetary Fund, Publication Services
P.O. Box 92780, Washington, D.C. 20090, U.S.A.
Tel.: (202) 623-7430 Fax: (202) 623-7201
E-mail: publications@imf.org
www.imfbookstore.org
www.elibrary.imf.org

Economic Inclusion and Financial Integrity

CHRISTINE LAGARDE
MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

Introduction

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 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.

The consecration of capitalism comes during the 19th 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.

> "What would the attributes of inclusive capitalism be? Trust, opportunity, rewards for all within a market economy"

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 wake-up 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.

"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."

> 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.

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 U.S., the share of income taken home by the top 1 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.

> "The principles of solidarity and reciprocity that bind societies together are more likely to erode in excessively unequal societies."

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 fourfold. 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 to 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 U.S., 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.

> 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 well-being 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.

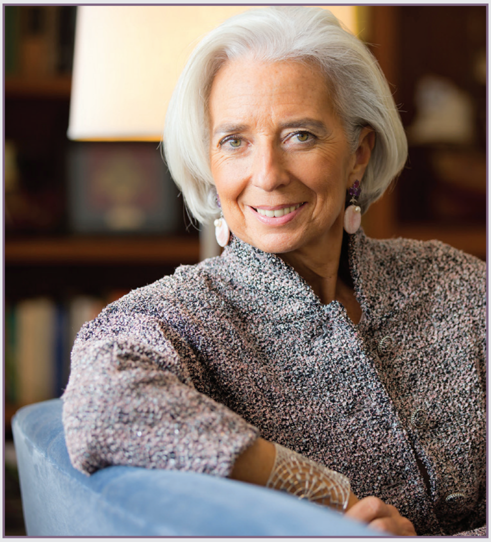
Conclusion

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.



Christine Lagarde

Born in Paris in 1956, Christine Lagarde completed high school in Le Havre and attended Holton-Arms School in Bethesda, Maryland (USA). She then graduated from law school at University Paris X and obtained a master's degree from the Political Science Institute in Aix-en-Provence.

After being admitted as a lawyer to the Paris bar, Lagarde joined the international law firm of Baker & McKenzie as an associate, specializing in labor, antitrust, and mergers and acquisitions. A member of the Executive Committee of the firm in 1995, Lagarde became the Chairman of the Global Executive Committee of Baker & McKenzie in 1999, and subsequently Chairman of the Global Strategic Committee in 2004.

Lagarde joined the French government in June 2005 as Minister for Foreign Trade. After a brief stint as Minister for Agriculture and Fisheries, in June 2007 she became the first woman to hold the post of Finance and Economy Minister of a G7 country. From July to December 2008, she also chaired the ECOFIN Council, which brings together economics and finance ministers of the European Union.

As a member of the G20, Lagarde was involved in the group's management of the financial crisis, helping to foster international policies related to financial supervision and regulation and to strengthen global economic governance. As Chairman of the G20 when France took over its presidency in 2011, she launched a wide-ranging work agenda on the reform of the international monetary system.

In July 2011, Lagarde became the eleventh Managing Director of the IMF and the first woman to hold that position.

Lagarde was named Officier in the Légion d'honneur in April 2012.

A former member of the French national team for synchronized swimming, Christine Lagarde is the mother of two sons.

ISBN 978-151358718-9