Inclusive Capitalism:
Creating a Sense of the Systemic

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Mark Carney *(www.bankofengland.co.uk)*

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.

Mark Carney

Societies aspire to this trinity of distributive justice, social equity and intergenerational equity for at least three reasons. First, there is growing evidence that relative equality is good for growth.[1] At a minimum, few would disagree that a society that provides opportunity to all of its citizens is more likely to thrive than one which favours an elite, however defined. Second, research suggests that inequality is one of the most important determinants of relative happiness and that a sense of community – itself a form of inclusion – is a critical determinant of well-being.[2] Third, they appeal to a fundamental sense of justice.[3] Who behind a Rawlsian veil of ignorance – not knowing their future talents and circumstances – wouldn't want to maximise the welfare of the least well off?

The problem: the growing exclusivity of capitalism

This gathering and similar ones in recent years have been prompted by a sense that this basic social contract is breaking down. That unease is backed up by hard data. At a global level, there has been convergence of opportunities and outcomes, but this is only because the gap between advanced and emerging economies has narrowed. Within societies, virtually without exception, inequality of outcomes both within and across generations has demonstrably increased.[4]

The big drivers of globalisation and technology are magnifying market distributions.[5] Moreover, returns in a globalised world are amplifying the rewards of the superstar and, though few of them would be inclined to admit it, the lucky.[6]

Now is the time to be famous or fortunate.

There is also disturbing evidence that equality of opportunity has fallen, with the potential to reinforce cultural and economic divides. For example, social mobility has declined in the US undercutting the sense of fairness at the heart of American society.[7]

Intergenerational equity is similarly strained across the advanced world. Social welfare systems designed and enjoyed by previous generations may prove, absent reform, unaffordable for future ones.[8] And environmental degradation remains unaddressed, a tragic embarrassment now seldom mentioned in either polite society or at the G20.

To maintain the balance of an inclusive social contract, it is necessary to recognise the importance of values and beliefs in economic life. Economic and political philosophers from Adam Smith (1759) to Hayek (1960) have long recognised that beliefs are part of inherited social capital, which provides the social framework for the free market.

Social capital refers to the links, shared values and beliefs in a society which encourage individuals not only to take responsibility for themselves and their families but also to trust each other and work collaboratively to support each other.[9]

So what values and beliefs are the foundations of inclusive capitalism?[10] Clearly to succeed in the global economy, *dynamism* is essential. To align incentives across generations, a *long-term* perspective is required. For markets to sustain their legitimacy, they need to be not only effective but also *fair*.

Nowhere is that need more acute than in financial markets; finance has to be *trusted*. And to value others demands *engaged citizens* who recognise their obligations to each other. In short, there needs to be a sense of society.

Social capital has been eroded

These beliefs and values are not necessarily fixed; they need to be nurtured. My 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.

All ideologies are prone to extremes. Capitalism loses its sense of moderation when the belief in the power of the market enters the realm of faith. In the decades prior to the crisis, such radicalism came to dominate economic ideas and became a pattern of social behaviour.[11] As Michael Sandel argued, we moved from a market economy to a market society.[12]

We simply cannot take the capitalist system, which produces such plenty and so many solutions, for granted. Prosperity requires not just investment in economic capital, but investment in social capital.

Market fundamentalism – in the form of light-touch regulation, the belief that bubbles cannot be identified and that markets always clear – contributed directly to the financial crisis and the associated erosion of social capital.

Ensuing events have further strained trust in the financial system. Many supposedly rugged markets were revealed to be cosseted:

- major banks were too-big-to fail: operating in a privileged heads-I-win-tails-you-lose bubble;
- there was widespread rigging of benchmarks for personal gain; and
- equity markets demonstrated a perverse sense of fairness, blatantly favouring the technologically empowered over the retail investor.[13]

Such practices widen the gap between insider and outsider returns and challenge distributive justice. More fundamentally, the resulting mistrust in market mechanisms reduces both happiness and social capital.

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It is necessary to rebuild social capital to make markets work. This is not an abstract issue or a naive aspiration. I will argue that we have already made a start with financial reform and that by completing the job, by returning to true markets, we can make capitalism more inclusive.

What then must be done?

There are a wide range of policies to promote inclusive capitalism from early childhood education, training and the importance of differentiated pathways and mixed-income neighbourhoods. These are all fundamentally political issues.

As an economist who should know the importance of comparative advantage, I will spend the balance of my time focusing on what central banks can do to support inclusive capitalism. The Bank of England's mission "to promote the good of the people of the UK by maintaining monetary and financial stability" suggests that central banks have an important role to play in supporting social welfare.

Central banks can contribute in two areas. First, our core macroeconomic objectives promote social welfare. Second, we can help to create an environment in which financial market participants are encouraged to think of their roles as part of a broader system. By building a sense of responsibility for the system, individuals will act in ways that reinforce the bonds of social capital and inclusive capitalism.

Some of this is straightforward. Inflation hurts the poor the most and the real costs of financial instability – unemployment and the seizure of credit – are likely to be felt most acutely by the poor.[14] Conversely monetary and financial stability are cornerstones of strong, sustainable and balanced growth and therefore directly affect distributive justice.

Some is more nuanced. While to not have acted would have been catastrophic for all, the distributional consequences of the response to the financial crisis have been significant. Extraordinary monetary stimulus – both conventional, through low short-term interest rates, and unconventional, through large scale purchases of assets – raised a range of asset prices, benefiting their owners, and lowered yields, benefiting borrowers at the expense of savers.[15]

Central banks are not blind to these issues. Rather we recognise that decisions to redistribute wealth are rightly political, as are most policies that promote social mobility. It is only in extreme circumstances, such as in the wake of a financial crisis, that we can have some limited influence on social mobility and intergenerational equity.

That is because the depth and duration of recessions can profoundly affect the opportunities over the rest of the lives of affected workers. For example, a rise in unemployment by 5 percentage points is estimated to imply an average initial loss of earnings for new college graduates of around 9 per cent, an effect which is estimated to fade only after a decade.[16] The persistent effects from adverse labour market conditions are much larger for individuals in the first year of their careers than for those with a few years of experience. And losses are magnified for those whose earnings are predicted to be lower, based on their college major. The current situation in many advanced economies is very challenging: over 40% of recent graduates in US are underemployed[17] and youth unemployment is around 50% in the worst affected countries in the Euro area.

With clear risks of a misplaced if not lost generation, to the extent appropriate under our mandates, the monetary policy response has represented a race against long-term (or hysteretic) unemployment. As Janet Yellen remarked, *"the risk that continued high unemployment could eventually lead to more-persistent structural problems underscores the case for maintaining a highly accommodative stance of monetary policy."* [18]

In Britain at least, these risks have been sharply reduced. *The Bank of England* has used a range of policies first to stimulate and then to secure the recovery. These have helped support the strongest job growth on record including record-high transitions back into employment by the longer-term unemployed. Longer-term social mobility will benefit from this track record.

Looking ahead, improvements in policy frameworks should help to reduce – but not eliminate – the incidence of financial crises. A core lesson of the recent episode is the need to think of the system as a whole. That is now reflected in the Bank of England's responsibility to bring a macroprudential perspective to financial stability policy.

Financial reform and rebuilding social capital

Central banks' greatest contribution to inclusive capitalism may be driving financial reforms that are helping to re-build the necessary social capital.

In doing so, we need to recognise the tension between pure free market capitalism, which reinforces the primacy of the individual at the expense of the system, and social capital which requires from individuals a broader sense of responsibility for the system. A sense of self must be accompanied by a sense of the systemic.

Consider four financial reforms that are helping to create this sense of the systemic and thereby rebuild trust in the system.

First, ending Too-Big-To-Fail

Perhaps the most severe blow to public trust was the revelation that there were scores of too-big-to-fail institutions operating at the heart of finance. Bankers made enormous sums in the run-up to the crisis and were often well compensated after it hit. In turn, taxpayers picked up the tab for their failures. That unjust sharing of risk and reward contributed directly to inequality but – more importantly – has had a corrosive effect on the broader social fabric of which finance is part and on which it relies.

By replacing such implicit privilege with the full discipline of the market, social capital can be rebuilt and economic dynamism increased.

The leaders of the G20 have endorsed measures to restore capitalism to the capitalists by ending too-big-to-fail and, in response, the *Financial Stability Board (FSB)* has identified systemically important institutions; made them subject to higher standards of resilience; and developed a range of tools to ensure that, if they do fail, they can be resolved without severe disruption to the financial system and without exposing the taxpayer to loss.

The basic point is that all market participants, large and small, should recognise that market integrity is essential to fair financial capitalism.

This is the year to complete that job. Governments must introduce legislative reforms to make all systemically important companies, including banks, resolvable. Jurisdictions must also empower supervisors to reach agreements for credible cross-border resolution plans. The *FSB* is developing proposals, for the G20 summit in Brisbane, on total loss absorbing capacity for institutions, so that private creditors stand in front of taxpayers when banks fail. In addition, we are working with industry to change derivative contracts so that all counterparties stay in while resolution of a failing firm is underway.

Second, creating fair and effective markets

In recent years, a host of scandals in fixed income, currency and commodity markets have been exposed. Merely prosecuting the guilty to the full extent of the law will not be sufficient to address the issues raised. Authorities and market participants must also act to re-create fair and effective markets.

In the *Bank of England's* view, changes to both the hard and soft infrastructure of markets will be required. Examples of the former include reforming the calculations of benchmarks such as Libor or the daily foreign exchange fixes. The upcoming *FSB* report on these issues, co-chaired by the *Financial Conduct Authority's (FCA)* Martin Wheatley and the *Federal Reserve's* Jeremy Stein, will be decisive in this regard. Consideration should also be given to increasing pre- and post-trade transparency in a host of fixed income markets and accelerating the G20 pledge to move the trading of all standardised derivatives onto electronic exchanges and platforms.

Such changes are vital, but they cannot anticipate every contingency or discipline every miscreant.

The scandals highlight a malaise in corners of finance that must be remedied. Many banks have rightly developed codes of ethics or business principles, but have all their traders absorbed their meaning? A first step to restore trust in markets might be to rely on traders' intuitive understanding of what makes a true market. Consideration should be given to developing principles of fair markets, codes of conduct for specific markets, and even regulatory obligations within this framework. There should be clear consequences including professional ostracism for failing to meet these standards.

The basic point is that all market participants, large and small, should recognise that market integrity is essential to fair financial capitalism. Confidence in the integrity of those markets needs to be reinforced alongside genuine competition to ensure that the needs of end customers are properly and effectively served. Doing so will reinforce the City's well-deserved reputation as the world's leading financial centre, with the most effective and efficient markets.

Third, reforming compensation

Dominic Barton and Mark Wiseman (2014) have detailed the need for long-term thinking by concentrating on shareholder incentives. A related lesson of the crisis was that compensation schemes that delivered large bonuses for short-term returns encouraged individuals to take on too much long-term and tail risk. In short, the present was overvalued and the future heavily discounted.

To align better incentives with the long-term interests of the firm – and, more broadly, society – major changes are underway. At the request of G20 Leaders, the *FSB* has developed the principles for sound compensation practices to align incentives with long-term risks. Here in the UK, the *Bank of England* has adopted a new code for banks prescribing deferred variable performance payments, introducing the ability to reduce deferred bonuses when subsequent performance reveals them not to have been fully deserved, and paying bonuses in stock rather than cash.

The deferral of bonuses awarded today allows them to be reduced before they are paid if evidence emerges of employee misconduct, error, failure of risk management or unexpectedly poor financial performance by the individual, their team or company.

We are continuing to refine our approach. *The Bank [of England]* has just completed a consultation on a requirement for variable remuneration to be clawed back *after* payment and will consult later in the year on new standards for bonus deferrals.

These provisions will apply not only to employees who are judged culpable directly, but also to others who could reasonably have been expected to identify and manage risks or misconduct but did not take steps to do so, and senior executives who could reasonably be deemed responsible by establishing the culture and strategy of the organisation. Where problems of performance or risk management are pervasive, bonuses should be adjusted for whole groups of employees.

Of course, no compensation package can fully internalise the impact of individual actions on systemic risks, including on trust in the system.[19] To do so, market participants need to become true stakeholders. That is, they must recognise that their actions do not merely affect their personal rewards, but also the legitimacy of the system in which they operate.

Fourth, building a sense of vocation and responsibility

To build this sense of the systemic, business ultimately needs to be seen as a vocation, an activity with high ethical standards, which in turn conveys certain responsibilities.

It can begin by asking the right questions. Who does finance serve? Itself? The real economy? Society? And to whom is the financier responsible? Herself? His business? Their system?

The answers start from recognising that financial capitalism is not an end in itself, but a means to promote investment, innovation, growth and prosperity. Banking is fundamentally about intermediation – connecting borrowers and savers in the real economy.

In the run-up to the crisis, banking became about banks not businesses; transactions not relations; counterparties not clients. New instruments originally designed to meet the credit and hedging needs of businesses quickly morphed into ways to amplify bets on financial outcomes.

When bankers become detached from end-users, their only reward becomes money. Purely financial compensation ignores the non-pecuniary rewards to employment, such as the satisfaction from helping a client or colleague succeed.

This reductionist view of the human condition is a poor foundation for ethical financial institutions needed to support long-term prosperity. To help rebuild that foundation, financiers, like all of us, need to avoid compartmentalisation – the division of our lives into different realms, each with its own set of rules. Home is distinct from work; ethics from law; the individual from the system.[20]

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This process begins with boards and senior management defining clearly the purpose of their organisations and promoting a culture of ethical business throughout them. Employees must be grounded in strong connections to their clients and their communities. To move to a world that once again values the future, bankers need to see themselves as custodians of their institutions, improving them before passing them along to their successors.

In the UK, two important initiatives are in train to help accomplish these ends.

The first is a new regime for regulating the senior-most managers of banks. That regime, proposed by the *Parliamentary Commission on Banking Standards* and now being established by the *Bank of England* seeks to reverse the blurring of the link between seniority and accountability that has developed over the years.

Its underlying principles are relevant across the financial sector. People who run major firms should have clearly defined responsibilities and behave with integrity, honesty and skill regardless of whether they work for global investment banks, regional building societies or insurance companies.

We are now considering a similar regime for senior persons in the insurance sector. This does not mean applying the banking regime indiscriminately. For one thing there is no statutory provision for applying a “reverse burden of proof” in insurance. For another, Solvency II requires us to monitor the fitness and propriety of a broader range of staff than in banks. In coming months we will build on the provisions of legislation to produce a regime that in spirit is aligned with the standards to which we hold bankers, but that in practice is a tailored approach for insurers. It will combine accountability with efficiency.

Ultimately, of course, social capital is not contractual; integrity can neither be bought nor regulated. Even with the best possible framework of codes, principles, compensation schemes and market discipline, financiers must constantly challenge themselves to the standards they uphold.

A meaningful change in the culture of banking will require a true commitment from the industry. That is why a second initiative, the creation of the *Banking Standards Review Council (BSRC),* is particularly welcome.[21] This new independent body, again proposed by the *Parliamentary Commission,* is designed to create a sense of vocation in banking by promoting high standards of competence and behaviour across the UK industry.

The *BSRC* will complement the work of regulators by setting out a single principles-based code of practice, based on the high-level principles now being considered by the *Prudential Regulation Authority* and *FCA*. Among other things, this should aim to guide behaviour in the face of conflicts of interest or of moral ambiguity. It will also identify activities where voluntary standards of good practice would be in the public interest, and work with industry to develop them. And it will engage with banks to establish good practice in developing the competence and training requirements of staff covered by the *Certified Persons* regime.

A prime objective of the *BSRC* will be to help individual banks and building societies to drive up standards of behaviour and competence through a process of internal and external assessment. It will work with banks to encourage a process of continuous improvement, and regularly assess and disclose the performance of each bank under the three broad headings of culture, competence and development of the workforce, and outcomes for customers.

The *BSRC* is an important sign of banks’ recognition of the need for change. Its impact over time will be a crucial test of the industry’s commitment to that change.

Conclusion

By encouraging enterprise and rewarding individual initiative, market-based economies provide the essential conditions for economic progress. But social capital must be maintained for that progress to be consistently delivered. The combination of unbridled faith in financial markets prior to the crisis and the recent demonstrations of corruption in some of these markets has eroded social capital. When combined with the longer-term pressures of globalisation and technology on the basic social contract, an unstable dynamic of declining trust in the financial system and growing exclusivity of capitalism threatens.

To counter this, rebuilding social capital is paramount.

Financial reform is now helping. Globally systemic banks are simplifying and downsizing. Some are de emphasising high-profile but risky businesses that benefited employees more than shareholders and society. Authorities are working feverishly to end too-big-to-fail. The structure of compensation is being reformed so that horizons are longer and rewards match risk. Regulation is hard-wiring the responsibilities of senior management. And new codes are seeking to re-establish finance as a true profession, with broader societal obligations. A welcome addition to these initiatives would be changes to the hard and soft infrastructure of financial markets to make them dynamic and fair.

Through all of these measures, finance can help to deliver a more trustworthy, inclusive capitalism – one which embeds a sense of the systemic and in which individual virtue and collective prosperity can flourish.

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In addition to his duties as Governor of the Bank of England, he serves as Chairman of the Financial Stability Board (FSB), First Vice-Chair of the European Systemic Risk Board, a member of the Group of Thirty and the Foundation Board of the World Economic Forum.

Mark Carney was born in Fort Smith, Northwest Territories, Canada in 1965.
He received a bachelor's degree in Economics from Harvard University in 1988. He went on to receive a master's degree in Economics in 1993 and a doctorate in Economics in 1995, both from Oxford University.

After a thirteen-year career with Goldman Sachs in its London, Tokyo, New York and Toronto offices, Mark Carney was appointed Deputy Governor of the Bank of Canada in August 2003. In November 2004, he left the Bank of Canada to become Senior Associate Deputy Minister of Finance. He held this position until his appointment as Governor of the Bank of Canada on 1 February 2008. Mark Carney served as Governor of the Bank of Canada and Chairman of its Board of Directors until 1 June 2013.

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[1] *See Ostry, Berg and Tsangarides (2014).*

[2] *See Alesina, Di Tella and MacCulloch (2004); Wilkinson and Pickett (2009).*

[3] *In 31 of the 39 countries surveyed by Pew Research in 2013, half or more of the population believed inequality to be a "very big problem" in their societies (Pew Research Center, 2013).*

[4] *The Gini coefficient pertaining to household disposable income rose from 0.26 in 1961 to 0.36 in 2008 in the UK, and from 0.39 to 0.46 over the same period in the US, according to data collected by Atkinson and Morelli (2014). Those data show this to be a common pattern across many advanced economies. In emerging markets, Gini coefficients remain high relative to the average for OECD countries, and rose between the 1990s and 2000s for India, China and the Russian Federation, though falling for Brazil (OECD, 2011a). The share of income received by the top 1 per cent of the population has also risen since the 1980s across many industrialised countries, including Australia, Canada, the United Kingdom and the United States (Atkinson and Morelli, 2014).*

[5] *See Autor, Katz and Krueger (1998) and Autor, Katz and Kearney (2008). For example the last 60 years have seen US returns to education rise despite a large increase in the supply of more educated workers. And there is evidence that increases in the employment of more skilled workers between the 1970s and the 1990s were greater in more computer intensive industries.*

[6] *As Michael Lewis has remarked, "Success is always rationalized. People really don't like to hear success explained away as luck – especially successful people. Lucky [to] live in the richest society the world has ever seen, in a time when no one actually expects you to sacrifice your interests to anything." Lewis (2012).*

[7] *See for example Corak (2013), who finds that the elasticity of a son's adult earnings with respect to his parents' earnings – the "intergenerational elasticity" – rose from 0.3 to around 0.55 between 1950 and 2000 in the US, indicative of a decline in social mobility. Corak has also shown that the intergenerational earnings elasticity tends to be higher in more unequal countries; a phenomenon termed the "Great Gatsby Curve" by Alan Krueger (2012).*

[8] *Government spending has increased in most countries around the world since the 1960s, reflecting increased spending on social protection, education and healthcare (IMF, 2014). And, looking forward, all OECD countries face increased budgetary pressure due to expected increases in age-related healthcare, long-term care and pensions (OECD, 2011b, Table 1.1). Merola and Sutherland (2012) analyse long-run fiscal sustainability in the context of these budgetary pressures.*

[9] *E.g. Putnam (2001).*

[10] *For a similar list see Shanmugaratnam (2013).*

[11] *Padoa-Schioppa (2010).*

[12] *Sandel (2012).*

[13] *See Martin (2012), also Lewis (2014).*

[14] *For example, using data on over 30,000 households in 38 countries, Easterly and Fischer (2001) find that the poor are more likely than the rich to mention inflation as a top national concern. Moreover, higher inflation is associated with greater income inequality in cross-country data (Albanesi, 2007). Financial crises in developing countries are associated with an increase in poverty and, in some cases, income inequality – see for example Baldacci, de Mello and Inchauste (2002). OECD (2013) documents an increase in market income inequality over the period 2007 2010 across developed countries, and reports with respect to the top and bottom 10% of the income distribution that "lower income households either lost more from income falls or benefitted less from the often sluggish recovery." In general it is likely that adverse income and employment shocks hurt the poor the most, for example because they lack the ability to hedge against these shocks and may lack access to credit markets to smooth them. Even if crises have a neutral effect on income inequality, the poor are much less able to absorb a cut in income (Honohan 2005).*

[15] *For an assessment of the distributional effects of the Bank of England's asset purchases, see* http://www.bankofengland.co.uk/publications/Documents/news/2012/nr073.pdf.

[16] *See Oreopoulos, von Wachter and Heisz (2012).*

[17] *See Abel, Deitz and Su (2014).*

[18] *Yellen (2012).*

[19] *More fundamentally, to think that compensation arrangements can ensure virtue is to miss the point entirely. Integrity cannot be legislated, and it certainly cannot be bought. It must come from within. See Carney (2013).*

[20] *As the CEO of TD Bank, Ed Clark, observed, "Bank leaders created cultures around a simple principle: if it's legal and others are doing it, we should do it too if it makes money. It didn't matter if it was the right thing to do for the customer, community or country." See Clark (2012).*

[21] *Sir Richard Lambert's Review was commissioned by the Chairmen of Barclays, HSBC, Lloyds, Nationwide, RBS, Santander and Standard Chartered in response to the recommendations of the Parliamentary Commission on Banking Standards. See* http://www.bankingstandardsreview.org.uk/.