Lifting the Small Boats

Address to Grandes Conférences Catholiques
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CHRISTINE LAGARDE
MANAGING DIRECTOR OF THE INTERNATIONAL MONETARY FUND

Introduction

Good evening! I am absolutely delighted to participate again in this prestigious conference, and I would like to thank Vice Premier Reynders for his kind introduction.

Last month, on May 6th, I almost choked on my morning yogurt when I saw the front page of a leading business newspaper. There it was—a league table of the world’s best-paid hedge fund managers. It showed that the highest earner was able to pocket $1.3 billion in 2014. One man, $1.3 billion!

Together, the 25 best-paid hedge fund managers earned a combined $12 billion last year, even as their industry suffered from largely mediocre investment performance.

This reminded me of a famous Wall Street joke—about a visitor to New York who admired the gorgeous yachts of the richest bankers and brokers. After gazing long and thoughtfully at these beautiful boats, the visitor asked wryly: “Where are their customers’ yachts?”

Why is this relevant right now? Because the theme of growing and excessive inequality is not only back in the headlines, it has also become a problem for economic growth and development. I would like to take an economic perspective on this with you tonight. I will not focus on the gorgeous yachts of the super-rich, who have become the face of a new Gilded Age. It is not immoral to enjoy one’s financial success.

But I would like to bring into the discussion what I would call the “small boats”—the livelihoods and economic aspirations of the poor and the middle class.

In too many countries, economic growth has failed to lift these small boats—while the gorgeous yachts have been riding the waves and enjoying the wind in their sails. In too many cases, poor and middle-class households have come to realize that hard work and determination alone may not be enough to keep them afloat.

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Too many of them are now convinced that the system is somehow rigged, that the odds are stacked against them. No wonder that politicians, business leaders, top-notch economists, and even central bankers are talking about excessive inequality of wealth and income. And these concerns can be heard across the political spectrum. In the United States, for example, President Obama and Republican leaders in the Congress agree that this is a defining issue of our time—one that needs not only a diagnosis but a cure.

My key message tonight is this: reducing excessive inequality—by lifting the small boats—is not just morally and politically correct, it is good economics.

You do not have to be an altruist to support policies that lift the incomes of the poor and the middle class. Everybody will benefit from these policies, because they are essential to generate higher, more inclusive, and more sustainable growth.

In other words, if you want to see more durable growth, you need to generate more equitable growth. With this in mind, I would like to focus on three issues:

1. The global economic outlook
2. The causes and consequences of excessive inequality
3. The policies needed for stronger, more inclusive, and more sustainable growth

1. The Global Economic Weather Is Not Helping Much

Let me start by describing the global economic weather map, as we see it. According to the IMF’s spring forecast, the global economy will grow 3.5 percent this year—about the same as last year—and 3.8 percent in 2016.

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Advanced economies are doing slightly better than last year. In the United States, the outlook holds for a strong expansion—the weak first quarter was just a temporary setback. Prospects in the euro area are improving, partly because of monetary easing by the European Central Bank. And Japan seems to finally be reaping the first rewards of its “three arrows” recovery strategy (monetary, fiscal, and structural).

Forecasts for most emerging and developing economies are slightly worse than last year, mainly because commodity exporters are affected by price declines, especially for oil. And recent data releases have reinforced this picture. But there is a tremendous diversity of national trends—from still strong growth in India to recession in Brazil and Russia.

So the good news remains that the global recovery continues. But growth remains moderate overall and uneven across countries.

What about the years beyond 2016, the second half of this decade? Well, here is where I have to share some not-so-good news with you. Our view at the IMF is that the growth potential of both advanced and emerging economies is likely to be lower in the years to come. This is partly because of changing demographics and lower productivity. Our concern is that this will bring more challenges in the labor markets, less-solid public finances, and slower improvements in living standards.

This is the “new mediocre” about which I have been warning. For the small boats it means that the wind is picking up, but it is not strong enough to reduce high unemployment. It is not strong enough to bolster middle-class incomes and drive poverty reduction. It is simply not strong enough to lift the small boats—even as the yachts are enjoying the breeze out on the high seas.

So, what is going on? Are we to resign in the face of unfavorable weather? Is there no hope for the captains of the small boats, whether they are here in Belgium or anywhere in the world?
2. Causes and Consequences of Excessive Inequality

The short answer is: there is hope, but to see it, we need to step back and look at the global picture before we zoom in on the country level.

Imagine lining up the world’s population from the poorest to the richest, each standing behind a pile of money that represents his or her annual income.

You will see that the world is a very unequal place. There is obviously a vast gulf between the richest and the poorest. But if you look at the changes in this lineup over time, you will notice that global income inequality—that is, inequality between countries—has actually fallen steadily over the past few decades.

Why? Because average incomes in emerging market economies, such as China and India, have risen much faster than those in richer countries. This shows the transformative power of international trade and investment. The massive global flows of products, services, people, knowledge, and ideas have been good for global equality of income—and we need more of that. So we can further reduce the gap between countries.

But—and this is a big “but”—we have also seen growing income inequality within countries. Over the past two decades, inequality of income has risen substantially in most advanced economies and major emerging market economies, especially in Asia and Eastern Europe.

In advanced economies, for example, the top 1 percent of the population now account for about 10 percent of total income. And the gap between rich and poor is even wider when it comes to wealth. Oxfam estimates that, in 2016, the combined wealth of the world’s richest 1 percent will overtake that of the other 99 percent of people. In the United States, a third of total wealth is held by 1 percent of the population. Latin America has been a bright spot with declining inequality levels—although it remains the world’s most unequal region.

If you put all this together, you see a striking divergence between a positive global trend and mostly negative trends within countries.

China, for example, has been at the sharp end of both trends. By lifting more than 600 million people out of poverty over the past three decades, China has made a remarkable contribution to greater global equality of income. But in the process, it has become one of the world’s most unequal societies—because many rural areas remain poor and because income and wealth have risen sharply in the cities and at the top levels of Chinese society.

In fact, economies like China and India seem to fit neatly into a traditional narrative that says that extreme inequality is an acceptable price to pay for economic growth. Much like air pollution, some may be tempted to say that inequality is simply part of the deal—get over it!
NEW CONSENSUS

But there is a growing new consensus that countries should not accept this Faustian tradeoff. For example, analysis\(^1\) by my colleagues at the IMF has shown that excessive income inequality actually drags down the economic growth rate and makes growth less sustainable over time.

Earlier this week, we released our latest IMF analysis\(^2\) that provides the hard numbers for my key message—that you need to lift the small boats to generate stronger and more durable growth.

Our research shows that, if you lift the income share of the poor and middle class by 1 percentage point, then GDP growth increases by as much as 0.38 percentage point in a country over five years. By contrast, if you lift the income share of the rich by 1 percentage point, then GDP growth decreases by 0.08 percentage point. One possible explanation is that the rich spend a lower fraction of their incomes, which could reduce aggregate demand and undermine growth.

In other words, our findings suggest that—contrary to conventional wisdom—the benefits of higher income are trickling up, not down. This, of course, shows that the poor and the middle class are the main engines of growth. Unfortunately, these engines have been stalling.

A recent OECD study, for example, shows that the living standards of the poor and lower middle class in advanced economies have been falling relative to the rest of the population. This kind of inequality holds back growth because it discourages investment in skills and human capital—which leads to lower productivity in a large part of the economy.

DRIVERS OF EXCESSIVE INEQUALITY

So, the consequences of excessive income inequality are increasingly clear—but what about its causes?

The most important drivers of extreme inequality are well-known—technological progress and financial globalization.\(^3\) These two factors have tended to widen the earnings gap between higher- and lower-skilled individuals, especially in advanced economies.

Another factor is the overreliance on finance in major economies such as the United States and Japan. Of course, finance—especially credit—is essential to any prosperous society. But there is growing evidence, including from IMF staff,\(^4\) that too much finance can distort the distribution of income, corrode the political process, and undermine economic stability and growth.

In emerging and developing economies, extreme income inequality is largely driven by an inequality of access—to education, health care, and financial services. Let me give you some examples:

- Almost 60 percent of the poorest youth population in sub-Saharan Africa has fewer than four years of schooling.
- Nearly 70 percent of the poor in developing economies give birth without access to doctors or nurses.
- More than 80 percent of the poor in developing economies do not have bank accounts.
Of course, another major factor is low social mobility. Recent studies have shown that advanced economies with lower levels of mobility across generations tend to have higher levels of income inequality. In these countries, parents’ income is a major determinant of children’s income. It suggests that, if you want to move up in society, you need to grow up on the right side of the tracks. This doesn’t sound fair.

With these kinds of disadvantages—with this kind of inequality of opportunity—millions of people have little or no chance of earning higher incomes and building up wealth. This is—in the words of Pope Francis—an “economy of exclusion.”


Policymakers can, in our view, generate a swell under the bow of the small boats. There are recipes for stronger, more inclusive, and more sustainable growth in all countries.

The first priority—the number one item on the list—should be macroeconomic stability. If you do not apply good monetary policies, if you indulge in fiscal indiscipline, if you allow your public debt to balloon, you are bound to see slower growth, rising inequality, and greater economic and financial instability.

Sound macroeconomic policies are the poor’s best friend—as is good governance. Endemic corruption, for example, can be a strong indicator of profound social and economic inequality.

The second priority should be prudence. We all know that actions need to be taken to reduce excessive inequality. But we also know that a certain level of inequality is healthy and helpful. It provides incentives for people to compete, innovate, invest, and seize opportunities—to upgrade their skills, start new businesses, and make things happen.

At their best, entrepreneurs have what economist John Maynard Keynes called “animal spirits”—a sometimes boundless confidence in their own unique ability to shape the future. In other words, standing out from the crowd is an essential driver of prosperity.

The next priority should be to adjust policies to country-specific drivers of inequality, including political, cultural, and institutional settings. No more one-size-fits-all, but smart policies—potential game changers—that could help reverse the trend toward greater inequality.

SMART FISCAL POLICY

One potential game changer is smart fiscal policy. The challenge here is to design tax and spending measures that have minimal adverse effects on incentives to work, save, and invest. The objective must be to promote both greater equality and greater efficiency.
This means widening the tax revenue base by—for example—clamping down on tax evasion; reducing tax relief on mortgage payments from which the rich benefit most; and reducing or removing tax relief on capital gains, stock options, and the profits of private equity investments funds, known as “carried interest.”

In many European countries, it also means reducing high labor taxes, including through cuts to employer social security contributions. This would provide a strong incentive to create more jobs and more full-time positions—which would help stem the tide of part-time and temporary jobs that have contributed to rising income inequality.

On the expenditure side, it means expanding access to education and health care. In many emerging and developing economies, it means reducing energy subsidies—which are costly and inefficient—and using the freed-up resources for better education, training, and stronger safety nets.

According to a recent IMF study, governments around the world will subsidize the cost of oil, gas, and coal to the tune of $5.3 trillion this year. This is the equivalent of what they spend on public health each year.

Promoting greater equality and efficiency also means relying more on so-called conditional cash transfers. These are immensely successful anti-poverty tools that have contributed significantly to the reduction in income inequality in countries such as Brazil, Chile, and Mexico.

During my recent visit to Brazil, I had the opportunity to visit a favela and witness first-hand the so-called Bolsa Familia program. This program provides aid to poor families—in the form of pre-paid debit cards—on condition that their children go to school and take part in government vaccination programs.

*Bolsa Familia* has proven to be both efficient and cost-effective: for expenditure of 0.5 percent of GDP per year, 50 million people are being supported—that’s one in every four Brazilians.

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STRUCTURAL ReFORMS

In addition to these smart fiscal policies, there is another potential game changer—smart reforms in vital areas such as education, health care, labor markets, infrastructure, and financial inclusion. These structural reforms are essential to lift potential economic growth and boost income and living standards over the medium term.

If I had to pick the three most important structural tools to reduce excessive income inequality, it would be education, education, education. Whether you live in Lima or Lagos, in Shanghai or Chicago, in Brussels or Buenos Aires, your income potential depends on your skills, your ability to harness technological change in a globalized world.

Higher incomes require higher human capital and policies that bring together more teachers and students in 21st century class rooms, with better books and access to online resources. Emerging and developing economies need to promote more equal access to basic education, while advanced economies need to focus more on the quality and affordability of university education. Even those countries with the highest educational standards should do more.

Another important tool is labor market reform. Think of well-calibrated minimum wages and policies to support job search and skill matching. Think of reforms to protect workers rather than jobs. In the Nordic countries, for example, workers have only limited job protection, but they benefit from generous unemployment insurance that requires jobseekers to find new positions. This model makes the labor market more flexible—which is good for growth—while safeguarding the interests of workers.

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Labor market reforms also have an important gender dimension. Across the globe, women have been facing a triple disadvantage. They are less likely than men to have a paid job, especially in the Middle East and North Africa. If they do find paid employment, it is more likely to be in the informal sector. And if they eventually get a job in the formal sector, they earn only three-quarters as much as men—even with the same level of education, and in the same occupation.

Countries like Chile and the Netherlands have shown that you can sharply increase female labor force participation through smart policies that emphasize affordable childcare, maternity leave, and workplace flexibility. You also need to remove legal barriers and tax discrimination that continue to hold women back in many countries.

Worldwide, there are about 865 million women who have the potential to contribute more fully to the economy. So the message is clear: if you care about greater shared prosperity, you need to unleash the economic power of women.

You also need to foster greater financial inclusion, especially in developing economies. Think of microcredit initiatives that turn poor people—mostly women—into successful micro-entrepreneurs—as I could recently see in Peru. Think of initiatives to build credit histories for people without bank accounts. Think of the transformative impact of cell-phone-based banking, especially in sub-Saharan Africa.

By improving their access to basic financial services, poor families in developing economies can invest more in health and education, which leads to higher productivity and higher income potential. If you want to reduce excessive income inequality in developing economies, you need to increase financial equality.
I sincerely hope that, by the end of this year, we will be able to look back and say, ‘We did it: we re-energized global economic growth. We reached a historic agreement on climate change. And we launched a brand new development agenda with ambitious goals and solid financing.’

Conclusion

All these policies and reforms require leadership, courage, and collaboration. This is why I am calling on politicians, policymakers, business leaders, and all of us here to translate good intentions into bold and lasting actions.

In particular, policymakers need to take advantage of what I think is a once-in-a-generation opportunity for development.

In September, the United Nations will host a major summit that will seek to replace the Millennium Development Goals with a new set of Sustainable Development Goals. And a U.N. conference next month will try to finance this ambitious new development agenda.

In December, leaders from 196 countries will meet in Paris to seek agreement on a comprehensive deal to cut carbon emissions. This deal would go a long way toward protecting the interests of the poorest members of society who are the first victims of climate change.

There are many cynical voices out there, questioning the need for action in these areas and declaring defeat well before the battle has begun. We must be able to prove these cynics wrong—by focusing minds, by forging partnerships, and by setting the right goals.

I sincerely hope that, by the end of this year, we will be able to look back and say, “We did it: we re-energized global economic growth. We reached a historic agreement on climate change. And we launched a brand new development agenda with ambitious goals and solid financing.”
On all these issues, I see an important role for the IMF. Our key mandate is to promote global economic and financial stability. This is why we have been deeply involved in development—by helping our 188 member countries to design and implement policies and by lending to countries in times of distress, so they can get back on their feet.

In sub-Saharan Africa, for example, many countries have applied sound macroeconomic policies over the past decade, and they are now reaping the benefits in the form of stronger growth and higher living standards. The IMF has supported these efforts through new instruments, such as zero-interest loans, as well as increased financing and capacity building.

We are also stepping up our research on inequality, gender, and climate-related issues because they are—as we say—macro-critical.

In addition, we are looking into how we might increase access to our loans for developing economies to help them buffer external shocks. In particular, we will increase our focus on helping the poorest and most fragile countries.

Consider the latest migrant tragedies in the Mediterranean and on Southeast Asian shores. These cramped migrant boats represent the most fragile states and communities. They are the smallest of the small boats—a powerful reminder of the most extreme inequality of wealth and income. The economy of exclusion is staring us right in the face.

It is often said that we should measure the health of our society not at its apex, but at its base. By lifting the small boats of the poor and the middle class, we can build a fairer society and a stronger economy. Together, we can create greater shared prosperity—for all.

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Endnotes


3. These two factors feature prominently in the academic literature and public discussions about inequality. The results of our latest Staff Discussion Note on the Causes and Consequences of Income Inequality confirm the findings in the literature.

4. A recent IMF Staff Discussion Note on Rethinking Financial Deepening (a) shows that, after a point, financial development damages growth. An IMF Working Paper (b) and a recent Bank for International Settlements paper (c) argue that it is possible to have too much finance.


5. Apostolic Exhortation by Pope Francis: “Just as the commandment ‘Thou shalt not kill’ sets a clear limit in order to safeguard the value of human life, today we also have to say ‘thou shalt not’ to an economy of exclusion and inequality.” Francis. 2014. Apostolic Exhortation Vatican—Evangelii Gaudium. November 24.

6. Half the rich world’s governments allow their citizens to deduct the interest payments on mortgages from their taxable income.

7. For more information on the Nordic model: IMF Staff Discussion Note on Labor Market Policies (a), IMF Working Paper on Jobs and Growth (b).


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.