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Spotlight on Reinvention

Wanted: A First National Bank of Innovation

by Edmund S. Phelps and Leo M. Tilman

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Some economists portray the U.S. government's initiatives in health care, climate change, and energy as engines of recovery. In their view, the state's policy levers can jack up the "new normal."

Such a mechanical view of the economy ignores a powerful force. Ever since Alexander Hamilton, the U.S. economy has been about ideas, experimentation, and exploration: businesspeople imagining new concepts and launching new ventures; entrepreneurs engineering new products or methods based on new ideas; marketers conceiving of niches for new products or new niches for old ones; managers and consumers assessing novel products; and financiers with strategic vision judging which innovations to back. Historically, the nation's dynamism—its ability and proclivity to innovate—has brought economic inclusion by creating numerous jobs. It has also brought real prosperity—engaging, challenging jobs and careers of self-realization and self-discovery.

Dynamism depends on multiplicity: variety among new ideas, a pluralism of beliefs among financiers, and diversity among consumers. That's why the state cannot generate the dynamism that a bottom-up system can. Think of an innovative firm working on a government contract. If its federal overseer sees no potential in a new idea, it will not come to fruition, and no one else is evaluating it to spot its worth. And when a decision by the single government agency results in a poor direction of resources, there will seldom be another agency to act as a backstop.

Dynamism has been in decline over the past decade. Venture capitalists bemoan a dearth of innovative ideas, and investors bewail a precipitous drop in their rates of return. IPOs of venture-capital-backed firms have steadily declined from the levels of the 1990s. Total venture investment is now running at less than $20 billion per year. Institutional investors and equity analysts now pressure CEOs of public companies to hit steadily growing earnings targets. That pressure distracts from long-term value creation. And the patent system, which at first encouraged invention, now threatens inventors with a tangle of infringement suits.

The current financial system is choking off funds for innovation. It lacks transparency, and incentives for risk takers at financial firms are fundamentally misaligned with the interests of stakeholders. Outdated accounting conventions and inadequate disclosures make it impossible to evaluate the business models and risks of financial firms. Excessive resources are allocated to proprietary trading, to lending to overleveraged consumers, to regulatory arbitrage, and to low-value-added financial engineering. Financing the development of innovation takes a backseat. Whatever self-reforms and regulatory reforms are now in the works, we do not believe they are likely to restore the rollicking times of old, when banks lent to and invested in businesses, steering the economic transformations of the late nineteenth and early twentieth centuries.

In the next decade, the inadequacy of the financial system will become only more glaring. Opportunities in clean technologies and nanotechnology require large-scale, long-term investments. Unfortunately, most financial firms lack the expertise to invest in business ventures on a sufficient scale, now that a generation of financial professionals has been trained to focus elsewhere. Unless something changes, the gap in funds for business innovation will keep widening.

An economically advanced country does not meet the needs of its people for prosperity and fulfillment if it does not examine its institutions, attitudes, and beliefs for ways to shore up its dynamism. Business innovation ought to be declared a public policy objective—one at least as important as boosting home ownership and agriculture.

To bolster innovation, we propose the establishment of a government-sponsored enterprise—the First National Bank of Innovation (FNBI). The institution we envision would be structured as a network of "merchant" banks that invest in and lend to innovative projects, and it would have some features of the Farm Credit System in the United States. A dedicated funding arm would raise money in the global capital markets at attractive rates, owing to FNBI's charter as a government-sponsored enterprise and to economies of scale. Banks would pass these funds to entrepreneurs at rates commensurate with the risk of their projects, as judged by qualified lending and investment officers. In contrast to today's financial institutions, these banks would be fully dedicated to "relationship-based" investing in or lending to entrepreneurial ventures in diverse industries and regions. From the outset, they would be adequately capitalized to reflect the risk/return characteristics of investing and lending to entrepreneurs. Thanks to comprehensive risk-based disclosure, strict oversight and transparency would emerge. That would foster judicious business decisions, competent risk management, and well-aligned incentives. Of course, every effort should be made to keep FNBI free of political patronage and popular pressures.

The United States faces no challenge more urgent than reviving its economic dynamism. Doing so will require a restructuring of the financial system so that once again global capital is routed to venturesome entrepreneurial projects.

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