

**Excerpts from Remarks on the Process of Creative Destruction to the Fort Worth  
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*The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.*

Long ago, the case for competition was articulated by such economists as Adam Smith and David Ricardo. At a private dinner last night, Chairman Greenspan reminded a group of us that Smith and Hume and Ricardo and Malthus and Keynes were all British, and it is to our British brethren that we owe our key understanding of economic principles. I would also draw on my own alma mater, the TCU of the East—Harvard—to credit one other economist for insights that put today’s world in perspective: a Czech educated in Vienna who taught at Harvard in the ’40s, Joseph Schumpeter. Schumpeter articulated the concept of “creative destruction.” Let me read you three excerpts from two of Schumpeter’s seminal works.

First, from *Capitalism, Socialism, and Democracy*: “The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers’ goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates.”

From that same page: “The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory...illustrate the same process of industrial mutation...that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one. This process of creative destruction is the essential fact of capitalism. It is...what every capitalist concern has got to live in.”

And from volume 1 of Schumpeter’s *Business Cycles*: “A railroad through new country, i.e., a country not yet served by railroads, as soon as it gets into working order upsets all conditions of location, all cost calculations, all production functions within its radius of influence; and hardly any ‘ways of doing things’ which have been optimal before remain so afterward.”

String the key operative phrases of those three citations together and you get the plot of this story, the plot of globalization: “The opening up of new markets, foreign or domestic . . . revolutionizes the economic structure, . . . destroying the old one, . . . creating a new one. . . . [It] upsets all conditions of location, all cost calculations, all production

functions, . . . and hardly any ways of doing things which have been optimal before remain so afterward.”

The master of creative destruction of syntax, Yogi Berra, put it more eloquently: Once you open new markets, “History just ain’t what it used to be.”

Globalization and the emergence of Chinese and Indian and other new competition is “creative destruction” writ large. We cannot hide from it. We can only rise to the occasion, channel it and adapt in order to benefit from it, rather than succumb to it.

I submit to you that the country that took in my father and mother—the land that made me possible—is flexible and dynamic and bold enough to succeed and, indeed, prosper from what Steve Roach of Morgan Stanley calls “the heat of China’s emergence.” We will do so as long as the Federal Reserve does its job of ensuring the monetary backdrop for sustained non-inflationary economic growth and as long as our political leaders refrain from fiscal promiscuity or from false remedies such as protectionism. I will do my part to ensure the former. You must do yours to ensure the latter with those you elect to represent you.

It will be more difficult for the other developed economic powers of the world to cope with the “Chinese heat.” In my book, the recent German elections were about preventing a hollowing out of the German economy: Now Chancellor Merkel, a woman who understands instinctively the shortcomings of socialism, must lead Germany through a tectonic transformation. France’s old political elite have resisted adapting, but new political actors are grappling with it, and time will tell if the French have the wherewithal to survive as a linchpin of the European economy.

Italy, the third European economic power, is also in need of radical transformation. At present, it is the English-speaking nations—England, Ireland, Australia, New Zealand and the U.S. (and, to give credit where credit is due, the Scandinavians and the Spaniards)—that are adapting best.

Which brings us to Japan and the current turmoil on the Japanese stock exchange and the issue of Livedoor and its CEO, Takafumi Horie.

I met Horie-san in 2003, when, if memory serves, his company’s shares were trading at 12 yen. They rose to over 700 yen before their recent drop to 496. I have no idea if Horie-san’s accounting practices are valid or not. The reason I mention this matter is by way of illustrating adaptation.

I lived in Tokyo in 1990 and ran my portfolio out of Nomura’s offices there while my oldest son played baseball in the Tokyo Junior Boys League. Perhaps because of that, when I was named deputy U.S. trade representative, I was appointed co-chairman, alongside the deputy foreign minister of Japan, of the Commission on Competition and Deregulation, a device thought up by President Clinton and Prime Minister Hashimoto to bring about structural change in the Japanese economy. I served in that capacity for three

years. Together, we engineered the initial restructuring of everything from the laws governing the size of retail stores to the electricity distribution system to the deregulation of telecommunications to the rules of corporate governance. The latter dealt with intricate details such as audit committee composition, the roles of directors and so on. I mention this to underscore only that I know enough about Japanese business practices and ethics so as to be dangerous!

Here is the point: From my personal perspective, the thing to watch in Japan is not whether Mr. Horie is good or bad. Or whether Fujitsu or any other company gets a further contract to improve the capacity of the Tokyo Stock Exchange, as discussed in this morning's *Financial Times*. The issue is *how* the Japanese deal with the situation and what their remedies tell us about their capacity to change and adapt a great and noble society that rose up from the ashes to become the world's second-largest economy.

There is a dynamic tension in Japan today. Prime Minister Koizumi has taken on the old political dinosaurs. Young entrepreneurs gathered in the new office buildings in the Roppongi Hills area of Tokyo and elsewhere have challenged the tightly interwoven culture of the old Japanese corporate hierarchy. Foreign investment has positioned itself for a sea change in Japan's direction.

We will learn a great deal about whether Japan has made the turn by how they handle Livedoor. If there is even a hint that the old order still has the power to stifle a "Roppongi Hills Tribe" entrepreneur because he dresses funny or is a college dropout or had the nerve to attempt to buy a baseball team or attempt a takeover of Nippon Broadcasting (assuming his tactics were legal and legitimate), then the Japanese authorities may well risk skepticism about their capacity to adapt to the demands of globalization and the creative destruction of the old order. If, on the other hand, they dispatch with the legitimate foibles of Horie or any other business operator in a manner that shows the rule of law, and practice, is geared to encouraging legitimate vehicles for creative destruction along Schumpeterian lines, then we will know that the Japanese are well on their way to joining us in handling "the heat of China's emergence."