For release on delivery
10:00 a.m. EDT
July 16, 2025

Booms and Busts and the Regulatory Cycle

Remarks by

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Washington, D.C.

July 16, 2025

Thank you for the opportunity to speak to you today.[1] I am here to discuss one of the most important resources that policymakers have: the lessons of history. In discharging my responsibilities at the Federal Reserve, I have been thinking a lot about history. Its study provides the opportunity to step out of the particular circumstances of today to inform our understanding of the core issues at the heart of financial regulation. While we must be attentive to new and even unprecedented challenges, experience shows that understanding the lessons of history gives policymakers a great advantage. Many of the decisions we face today have, in some form, been confronted by previous generations of policymakers.

In these remarks, I want to discuss a particular pattern in the history of the financial system, which is the relationship between regulatory weakening and the economic and financial cycle of booms and busts. My intent is not to re-hash well-examined facts or to go over past historical episodes chapter and verse. Rather, I aim to offer a perspective on this historical throughline that focuses on the regulatory cycle.

It's widely accepted that the economy and financial system experience cyclical booms and busts. Booms have historically been characterized by a multitude of good things. These can include fast economic growth, workers who had been sidelined entering the workforce and improving their lives, and financial innovations that often make credit or investments more readily available. At the same time, some of the characteristics of a boom economy, such as rapid increases in credit and in financial market activity, as well as greater risk-taking and leverage, can sow the seeds of busts. In busts, economic activity and lending contract and asset prices decline. This can lead to

[1] The views expressed here are my own and are not necessarily those of my colleagues.

rapid deleveraging and dislocation throughout the financial system, which worsen the downturn, causing job losses and business closures, homes lost and lives upended.

There are usually multiple causes that drive booms and make busts so terrible, some unique to each individual episode. But one factor that is common to many past cycles of boom and bust is weakening financial regulation. Weakening regulation often drives risk-taking and increases bank fragility during the boom, making the ensuing bust more painful. Indeed, economic research suggests that weaker regulation leads to more bank failures, setting the stage for worse recessions.[2] Moreover, because the financial system evolves so rapidly, regulation must also continuously adjust. Much regulatory weakening occurs simply when regulators fail to keep pace, while at other times, there is a deliberate action to lower regulatory burden that ends up miscalculating the risk involved. Let me be clear here that, when I refer to regulatory weakening, I mean not only direct deregulatory actions by regulators or legislators, but also failure of the regulatory framework to keep up with changing circumstances.

In principle, financial regulation should incentivize banks to engage in responsible risk-taking and build up resources in good times, so that they can deal with times of financial stress and continue their vital role in the economy in bad times. The prosperity that accompanies a healthy economy should allow banks to invest in improved risk management and strong financial resources. However, a healthy economy can also reduce the effectiveness of regulatory constraints on bank risk-taking. This can occur for a host of reasons, including behavioral biases, political pressure, market dynamics, and

[2] For example, see Paul H. Kupiec and Carlos D. Ramirez (2013), "Bank Failures and the Cost of Systemic Risk: Evidence from 1900 to 1930," *Journal of Financial Intermediation*, vol. 22 (3), pp. 285–307; and Kris James Mitchener (2005), "Bank Supervision, Regulation, and Instability during the Great Depression," *The Journal of Economic History*, vol. 65 (1), pp. 152–85.

the tendency for innovation to move more quickly than regulators. These dynamics can result in regulatory weakening during boom times. When actively pursued, this weakening often appears justified at the time and may be implemented by well-meaning policymakers who simply miscalculate the long-run effects of their actions.

My purpose in these remarks is to recount several boom-and-bust episodes in American history and identify some lessons that can guide policymakers entrusted with the responsibility of promoting a strong and stable banking system. This history demonstrates the connection between regulatory weakening and cycles of boom and bust. I don't mean to suggest that more regulation is always better or that repealing and reforming regulations isn't sometimes appropriate to remove obsolete rules and relieve unnecessary burden. But, if we can at least agree that regulation should seek to limit devastating financial crises, then the history that I will describe today offers some lessons for anyone thinking about regulatory policy.

There are, of course, lots of examples to choose from, both in the United States and abroad, but I'll focus on the Great Depression, the Savings and Loan (S&L) crisis, and the Global Financial Crisis. I will then discuss some possible reasons that similar episodes could recur and conclude with some thoughts on the lessons we can learn.

The Great Depression

Let's start with the biggest and most widely studied bust in U.S. history, the Great Depression. Scholars continue to debate its causes, which were multiple and complex. One compelling argument focuses on the failure of regulation to keep pace with the innovations of the Roaring Twenties. As I said, I view such regulatory stagnation as a form of weakening. This weakened regulatory environment played a role in setting the stage for and then exacerbating the bust. Weakened regulation that had failed to keep up with the times left banks unable to weather shocks to the economy. The banking sector's collapse was a significant factor in making the Great Depression the most severe economic crisis that this country has ever experienced.[3]

The Roaring Twenties expansion was powered by the post-war recovery and technological advances in transportation, manufacturing, and communications. Stock markets grew quickly to help finance this innovation, while residential and commercial real estate investment surged and swelling demand for consumer durables led in turn to increased demand for financing.[4] As credit needs escalated, there was intensifying competition among banks; savings and loan institutions (S&Ls); and rapidly growing nonbank finance companies, trust companies, and other financial vehicles.

The 1920s were also characterized by high levels of financial speculation, both inside and outside the banking sector. Banks engaged in speculation through nonbank affiliates and supported speculation by lending. At the same time, many banks were relatively thinly capitalized and overly concentrated, especially given the lack of federal deposit insurance at the time. In addition, many states had prohibitions on branching that prevented banks from diversifying their portfolios and inhibited local competition,

[3] Ben Bernanke (1983), "Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression," *American Economic Review*, vol. 73 (3), pp. 257–76.
[4] See Arthur E. Wilmarth Jr. (2003), "Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis? Evidence from the Past Three Decades and the Great Depression," in Benton E. Gup, ed., *Too Big to Fail: Policies and Practices in Government Bailouts* (Santa Barbara: Greenwood Publishing Group), pp. 77–105; and Barry Eichengreen and Kris Mitchener (2003), "The Great Depression as a Credit Boom Gone Wrong," BIS Working Papers No. 137 (Basel, Switzerland: Bank for International Settlements, September) https://www.bis.org/publ/work137.pdf.

keeping many struggling banks alive.[5] The stock market boomed, margin lending grew dramatically, and insider trading and market manipulation were rampant.

As the financialization of the economy increased, the regulatory framework failed to keep up. Outdated branching restrictions remained, failing to reflect the size and dynamism of the modern economy. Banks gained permission to engage in new activities, such as real estate lending and certain activities in the securities markets; however, capital requirements and other rules were not adjusted to reflect potential increased risks from these new activities.[6] The cumulative effect of these events was a significantly weakened regulatory environment and a substantial buildup in risk, without a commensurate increase in resources to allow the sector to withstand the risks posed.

Looking back, we know that, when the economic shock hit, the banking system magnified that shock. The boom of the Roaring Twenties started to go bust in 1929, when the fast growth of the past decade turned to contraction, followed by a series of financial and banking crises. In all, approximately 9,000 of the nation's 23,000 banks failed, resulting in major losses to depositors, given the lack of federal deposit insurance, and a significant contraction in credit that deepened and lengthened the economic

[5] National banks received authorization to engage in branching, subject to state law, in 1927 but interstate branching remained prohibited.

[6] Before 1900, national banks were prohibited from underwriting, dealing, or investing in securities. However, federal authorities loosened these restrictions by allowing national banks to establish bond departments that could underwrite, sell, and invest in debt securities. Although restrictions on dealing in stock remained, national banks were able to circumvent these restrictions by organizing affiliates that engaged in the full range of activities with regard to both stocks and bonds. Federal regulatory authorities did not interfere with these affiliate activities. Scholars continue to debate the extent to which this underwriting activity was risky for the banks. See Wilmarth Jr., "Does Financial Liberalization Increase the Likelihood of a Systemic Banking Crisis?" (see note 4); and Eugene Nelson White (1986), "Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks," *Explorations in Economic History*, vol. 23 (1), pp. 33–55.

downturn.[7] Notably, banks in states that had more robust regulatory frameworks—for example, those that applied higher capital requirements—had lower rates of failure.[8]

In response to the financial collapse in the Great Depression, Congress adopted reforms aimed at addressing risks that had driven those panics. Among these steps, Congress established the Federal Deposit Insurance Corporation and federal deposit insurance to reduce the risk of bank runs and protect retail depositors. Congress increased regulatory oversight of banks and separated commercial and investment banking. Congress also enacted strong securities laws and created the Securities and Exchange Commission (SEC). Overall, these steps helped stabilize the financial sector and ushered in a long period of quiescence in banking.

The Savings & Loan Crisis

My second example today is the S&L crisis of the 1980s and early 1990s, which did substantial harm to millions of Americans and the financial system and was extremely expensive to resolve. In this episode, in contrast to the Great Depression, affirmative deregulation led to excessive risk-taking by S&Ls, as well as banks, during a boom period. As circumstances soured, revealing weaknesses, Congress attempted to bolster the S&L sector by loosening the regulatory framework further. This failed to resolve the underlying stress and instead further fueled the buildup in risk-taking, worsening the losses in the subsequent bust.

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[7] See Federal Reserve History (2013), "Bank Holiday of 1933," webpage, https://www.federalreservehistory.org/essays/bank-holiday-of-1933; Board of Governors of the Federal Reserve System (1934), *20th Annual Report, 1933* (Washington: Board of Governors); and Social Security Administration (n.d.), "Social Security History," webpage, https://www.ssa.gov/history/bank.html; and David C. Wheelock (n.d.), "The Great Depression: An Overview," Federal Reserve Education, https://www.federalreserveeducation.org/resources/lessons/lesson--great-depression-introduction-essay-wheelock.pdf.

[8] See Mitchener, "Bank Supervision, Regulation, and Instability" (see note 2).

Let me first set the stage. The years leading up to the S&L crisis were characterized by dramatic growth in business credit, in the course of the economic expansion that began in 1982. At the beginning of this period, the S&L sector primarily served the residential real estate market because of restrictions on S&L activities. These restrictions eased over the 1980s, allowing S&Ls to get significantly larger and engage in new kinds of lending; however, these changes were not accompanied by sufficient regulatory enhancements to account for increased risks. This expansion in S&L activity also presented new competition with commercial banks, which had themselves built up significant risks as they expanded into new activities.[9]

At the same time, both S&Ls and banks were increasingly under pressure due to both high inflation and high interest rates, which disrupted their funding models.[10] Competition for customer funds increased dramatically, especially because of the rise of money market mutual funds, which had grown rapidly. When Congress removed outdated deposit rate caps to allow banks and S&Ls to more effectively compete for funds, it did so without implementing adequate safeguards against these institutions taking on excessive risk. This led many S&Ls to engage in increasingly risky projects to compensate for escalating funding costs. Banks also increased their deposit rates and took on more risk.

As vulnerabilities at S&Ls became evident, Congress, federal regulators, and the states attempted to bolster both sectors with the hope of allowing them to outgrow those

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[9] Federal regulators, as well as many state legislatures and state banking authorities, expanded the scope of permissible activities for banks during this period.

[10] For example, S&Ls made long-term, fixed rate residential mortgage loans, funded with short-term retail liabilities. As rates increased, S&Ls' existing mortgage portfolios decreased in value, because of their fixed rates. At the same time, S&Ls were forced to pay higher rates on their liabilities. This situation threatened their continued viability.

weaknesses. For instance, Congress and the states reduced restrictions on S&Ls' ability to invest in commercial and consumer loans.[11] These changes contributed to the boom in commercial real estate lending, which became a key source of vulnerability. In addition, Congress and the Federal Home Loan Bank Board, the federal S&L regulator at the time, weakened capital requirements and the enforcement of those requirements for the S&L sector.[12] This allowed institutions to become weaker and poorly capitalized entities to stay afloat, leaving S&Ls as a whole badly positioned to weather adverse conditions.

The bust, when it came, was severe. S&L losses continued to mount throughout the 1980s. Many banks also experienced severe stress. These difficulties were amplified by an eventual decline in real estate values and problems in the agricultural and energy sectors. In 1980, there were just under 4,000 S&Ls. By 1989, that number had fallen to below 3,000, with over 500 of the remaining institutions insolvent as judged by book value. And over 1,600 banks failed between 1980 and 1994. Regulatory weakening had propped up tottering institutions, allowing zombie institutions to persist, accumulating much greater losses than they otherwise would have. The process of cleaning up the sector began in earnest in the late 1980s and continued into the mid-1990s, with a final

[11] Many states simultaneously relaxed their own activities restrictions for state charters to allow for real estate investment.
[12] For instance, the Federal Home Loan Bank Board reduced net worth requirements for federally insured S&Ls to allow troubled S&Ls to avoid closure and hopefully recover once interest rates declined.

cost of $160 billion, roughly 5 percent of gross domestic product at the time.[13] And the cost of resolving insured banks that failed during this period was $36 billion.[14]

Congress implemented significant reforms in response to the S&L crisis, including stricter capital and accounting requirements, limits on insured depository institutions' investment powers, and expansions of regulators' enforcement authority. These changes paved the way for stability in the banking sector for some time.

The Global Financial Crisis

I'll turn now to my final example, the Global Financial Crisis, which had devastating effects for the millions of people who lost their livelihoods, their homes, and their businesses.

In the decade leading up to the crisis, America experienced rapid credit growth and a housing boom. There was optimism about the benefits of financial innovation, such as securitization of home loans, and belief in the power of market discipline as a form of self-regulation. Home prices and mortgage debt accelerated in tandem, driven by a mutually reinforcing cycle of optimism, with home prices roughly doubling between 1997 and 2006, and even larger increases in mortgage debt.[15] Amid this boom, lending standards dropped, driven by investor demand for mortgage-backed securities, which

[13] This figure refers to the cost of resolving S&Ls that failed during the crisis. See Alane Moysich (1997), "The Savings and Loan Crisis and Its Relationship to Banking," in *History of the Eighties--Lessons for the Future,* vol. 1: *An Examination of the Banking Crises of the 1980s and Early 1990s* (Washington: Federal Deposit Insurance Corporation), pp. 167–88, https://www.fdic.gov/resources/publications/history-eighties/volume-1/history-80s-volume-1-part1-04.pdf; and U.S. Bureau of Economic Analysis (2025), Gross Domestic Product, via FRED, Federal Reserve Bank of St. Louis, June 26, https://fred.stlouisfed.org/series/GDP (accessed July 15, 2025, 1982:Q4 used as gross domestic product reference point).
[14] This figure reflects costs associated with bank failures from 1980 through 1994.
[15] See Federal Housing Finance Agency (2025), All-Transactions House Price Index for the United States, via FRED, Federal Reserve Bank of St. Louis, May 27, https://fred.stlouisfed.org/series/USSTHPI (accessed July 15, 2025); and Board of Governors of the Federal Reserve System (2019), Mortgage Debt Outstanding, All holders, via FRED, Federal Reserve Bank of St. Louis, December 12, https://fred.stlouisfed.org/series/MDOAH (accessed July 15, 2025).

were increasingly opaque and risky in their design but still highly rated by the rating agencies. There was substantial growth in the over-the-counter (OTC) derivatives market, including new forms of credit derivatives. Money market funds boomed, becoming increasingly linked to the off-balance sheet business of banks.[16] These developments led to the emergence of large, short-funded, and interconnected financial entities—both banks and nonbanks.

The regulatory environment failed to keep up with these changes in activity and the increasing complexity of financial institutions and markets, and regulatory weakening heightened vulnerabilities. The Gramm-Leach-Bliley Act, enacted in 1999, permitted the creation of financial holding companies that could engage in the full range of financial activities; however, the act did not put in place a regulatory framework commensurate with the full range of financial risks and permitted nonbank firms such as investment banks and insurance conglomerates to compete with banks wholly outside its framework. The Commodity Futures Modernization Act of 2000 exempted OTC derivatives transactions from virtually all regulation and oversight by the Commodity Futures Trading Commission and SEC.

In the lead-up to the crisis, regulators cut oversight further. A striking image from the time featured the head of one financial regulatory agency wielding a chainsaw to

[16] For example, many banks created asset-backed commercial paper (ABCP) programs as conduits that allowed them to fund bank assets without bringing them on balance sheet, thereby avoiding regulatory capital treatment. However, this approach created significant risks because the primary holders of ABCP were money market mutual funds, which are ultra-sensitive to payment delays and themselves subject to run risk. Money market funds also similarly funded other parts of banks' balance sheets in the lead-up to the crisis. In addition, other private cash-like instruments, such as auction rate securities, repurchase agreements based on ABCP, and other short-term debt instruments that were treated like money created new vulnerabilities as they grew and subsequently collapsed.

demonstrate his commitment to slashing regulations.[17] The competitive landscape and regulatory lacuna led to a race to the bottom in standards for underwriting and issuing mortgage loans and securities, and transactions became increasingly funded by opaque and unstable short-term wholesale funding. Consumers were left unprotected as the subprime crisis grew. In addition, the largest investment banks, which were overseen by the SEC, increased their leverage with heavy reliance on short-term funding, leaving them increasingly vulnerable to any losses. These are just a few examples of the widespread failures in financial regulation and supervision that occurred in both the banking and nonbanking sectors in the lead-up to the crisis.

The resulting recession and financial crisis saw the deepest and longest contraction in economic activity since the second world war, the collapse of large financial institutions, significant government support to keep the financial system afloat, and a prolonged period of slow growth.

In response to this crisis, Congress passed the Dodd-Frank Act, a reform package that, among other things, strengthened bank capital, addressed off-balance sheet exposures, and provided for stress testing. Consumer protections were strengthened, and a new Consumer Financial Protection Bureau was established. Supervisors ramped up forward-looking supervision. In addition, banking regulators adopted capital and liquidity reforms, which substantially improved the resiliency of the banking sector. Studying the role that regulatory weakening played in the crisis provides a powerful reminder of the importance of preserving these regulatory gains.

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[17] Binyamin Appelbaum and Ellen Nakashima (2008), "Banking Regulator Played Advocate over Enforcer," *Washington Post*, November 23.

Lessons for Policymakers

Reviewing these three examples together, it is striking to see the pattern of regulatory weakening during a boom, including the failure of the regulatory environment to keep pace with the evolving financial sector, and how this weakening lays the foundation for a subsequent bust. Why do we continue to see these cycles?

Some reasons are psychological, others political. Humans have short memories, especially for experiences we might like to forget. The further we get from a crisis, the more its causes fade from memory and the less likely a recurrence seems. We become more likely to view regulations as unduly burdensome and place less value on the protection they offer from downside risk. The financial sector itself lobbies hard to weaken regulation, which is often effective when the last crisis seems far away.

Credit cycles, financial innovation, and the evolving needs of the economy are also significant contributors. As the economy changes, so do financing needs. This makes it harder to recognize when things are running too hot. In addition, regulators are understandably cautious about restraining innovations that have societal benefits, which may hinder their ability to reduce associated risks. Longstanding regulations can be subject to regulatory arbitrage, making them less effective as activities migrate outside the regulated system. These dynamics make the financial sector unstable, feeding the boom-and-bust cycle.

How can we do better?

The first lesson is to approach the financial system with a through-the-cycle perspective and avoid thinking "this time is different." In each of the booms I have covered, there was a heady confidence that market discipline would control risk-taking, that downside risks were so implausible as not to merit attention, and that easing regulation was justified. With such confidence, insufficient thought was given to how regulatory weakening might create new vulnerabilities. A bit of humility would have helped. While it is true that regulation must evolve with the economy and financial system, we need to recognize that relaxing rules can create vulnerabilities. Changes in the markets themselves can also weaken the effectiveness of regulations.

The second lesson is that policymakers should resist the pressure to loosen regulations or to refrain from imposing regulation on new activities during the boom times. With past economic downturns in the rearview mirror, regulations start to be seen as a limitation on growth, rather than necessary protection against vulnerabilities. As became evident in past episodes, vigilant supervision and prudent rules on risk-taking are important to prevent future crises. While there is a tradeoff, it is important to have appropriate protections in place to reduce the risks and costs of the resulting busts.

Third, regulation cannot be static. If regulation fails to keep up with evolution of the financial sector, it can create new risks or hinder growth.

To conclude, an important lesson we can draw from U.S. financial crises is the role that ill-advised weakening of the bank regulatory framework played in those crises. It is well within our ability, and is our duty as regulators, to learn from these episodes to avoid making the same mistakes. In doing so, we can help to ensure that the financial system is prepared to weather downturns and continue to serve households and businesses.