

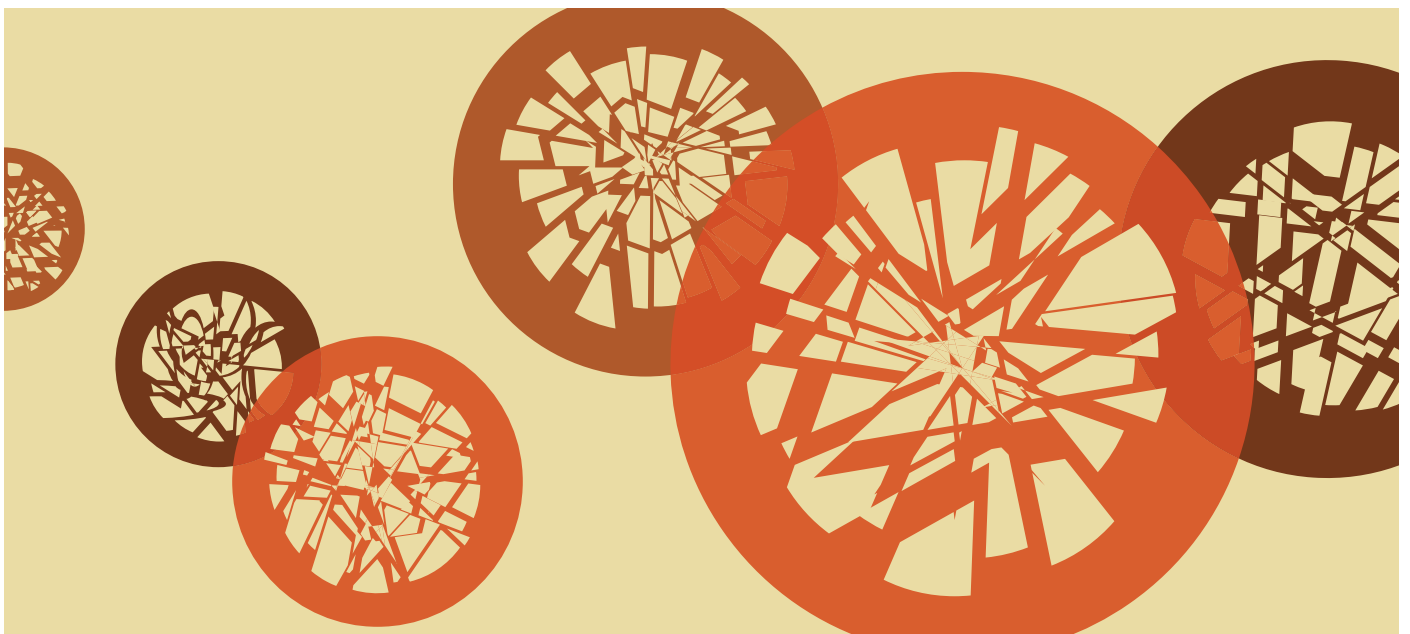
STRATEGY

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Financial crisis and reform: Looking back for clues to the future

Changes reaching far beyond the financial sector have followed every major US financial crisis that sparked an economic downturn.

Robert E. Wright



For the many global companies affected by the US business climate, an obvious question in the wake of the financial system's recent upheaval is the likelihood and extent of impending changes in the country's regulatory, political, and structural environment. History provides three clear lessons: first, reforms followed every major US financial crisis that led to an economic downturn. Second, the length and severity of the postcrisis recession have historically been approximately proportional to the degree of change that follows the recession. Finally, the resulting shifts commonly extend well beyond the financial-services sector.

Mild recessions, like those of 1990–91 and 2001, have typically led to piecemeal regulatory reform (exhibit, on the next page). Steeper downturns portended seismic changes, such as major political realignments and even revolution. (Scholars are just now recognizing the important role that the real estate bust of 1764–68—when land prices fell by half to two-thirds in about a year and thousands of Americans ended up in debtors' prison—played in the imperial crisis culminating in the events of July 1776.) Similarly, the Panic of 1857 in the United States and the subsequent recession helped bring on the Civil War by exacerbating sectional tensions over slavery and states' rights and helping the modern Republican Party to coalesce. During the Great Depression, some historians believe, the federal government averted rebellion thanks only to the extraordinary changes ushered in by the first New Deal.

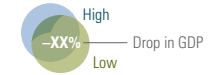
Nothing comparably dramatic seems imminent, but this doesn't mean that game-changing regulatory reforms are impossible. Already, the subprime-mortgage and liquidity crises have vastly increased the power of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), and the Treasury Department. While it's difficult to predict what other shifts will transpire, the breadth of change that has historically resulted from financial crises is worth bearing in mind. The Panic of 1873 and the subsequent long recession, for example, helped spur labor and agrarian unrest. Similarly, the recession of 1893–97 invigorated Populism and Progressivism and paved the way for the turn-of-century Great Merger Movement, which created giant corporations such as U.S. Steel and International Harvester. The Great Depression gave rise to the Glass–Steagall Act (which separated investment and commercial banking for more than 60 years), the FDIC, the Securities and Exchange Commission, and Social Security. *Q*

About the author

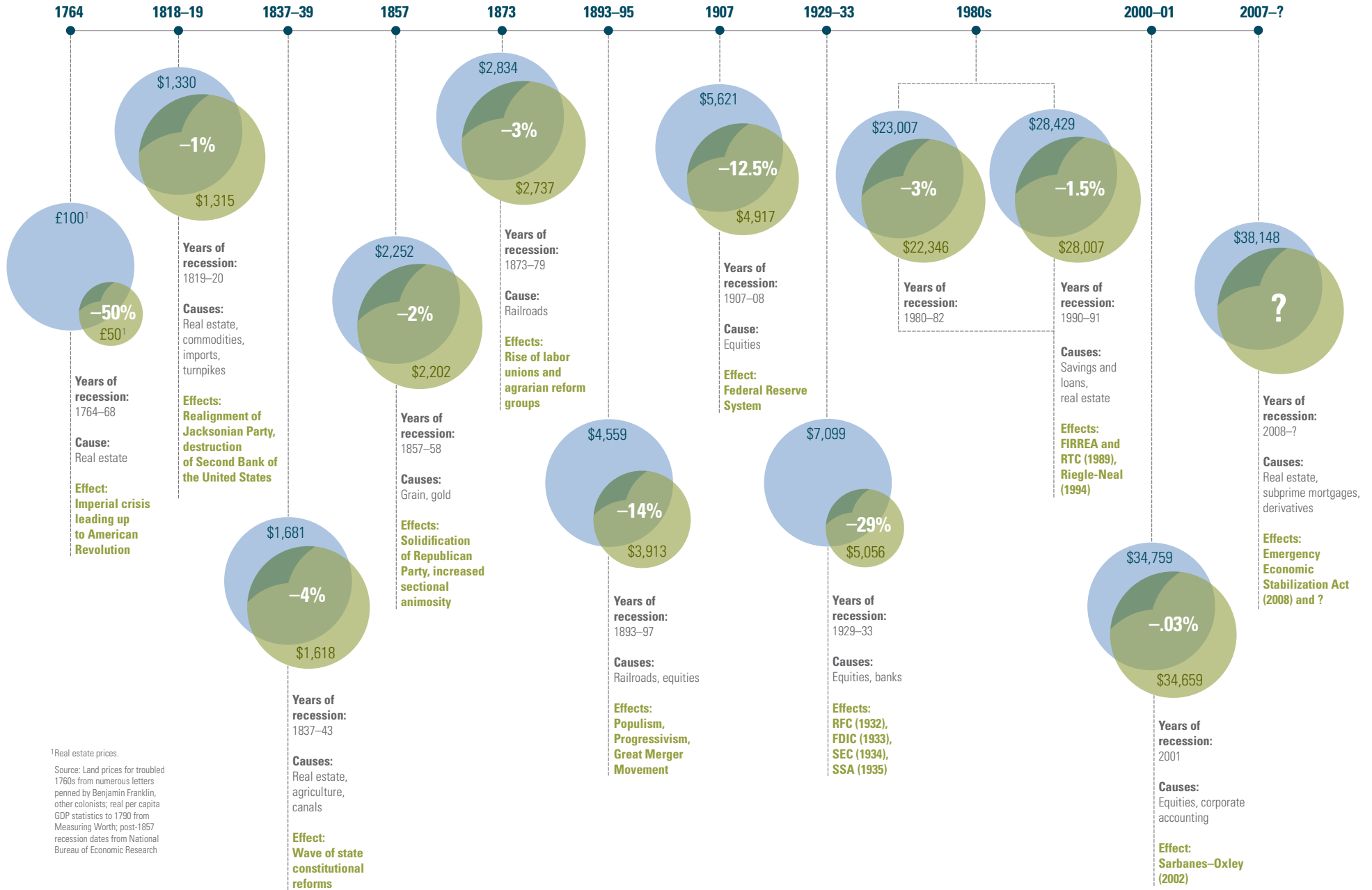
Robert Wright is a clinical associate professor of economics at New York University's Stern School of Business, where he teaches business, economic, and financial history.

Times of crisis

GDP per capita, real 2000 dollars



Crisis year(s):



¹Real estate prices.
Source: Land prices for troubled 1760s from numerous letters penned by Benjamin Franklin, other colonists; real per capita GDP statistics to 1790 from Measuring Worth; post-1857 recession dates from National Bureau of Economic Research