Tulip Mania ... The Greater Fool Theory

If you think that market crashes are a modern thing caused by pandemics, tensions between countries or financial industry misdeeds? Think again…

One frosty winter morning, at the start of 1637, a sailor presented himself at the counting house of a wealthy Dutch merchant and was offered a hearty breakfast of fine red herring.

The sailor noticed an onion - or so he thought - lying on the counter. According to Charles Mackay, writing in Scotland 200 years later, he pinched it.

"He slyly seized an opportunity and slipped it into his pocket, as a relish for his herring, and proceeded to the quay to eat his breakfast. Hardly was his back turned when the merchant realized that his valuable Semper Augustus tulip bulb, worth 3,000 florins, or about $355 was gone!"

Relative to the wages of the time, that is nearly $1m in today's money.

Seeking a zesty accompaniment to his fish, the sailor had unwittingly pilfered not an onion, but something a lot more valuable.

And in early 1637, tulip bulbs were reaching some truly extraordinary prices.

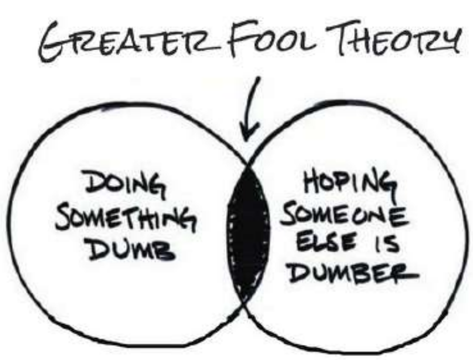
Then, very suddenly, it was over.

Tulip Mania is often cited as the classic example of a financial bubble - when the price of something goes up and up, not because of its intrinsic value, but because people who buy it expect to be able to sell it again at a profit.

It may seem foolish to pay $1m for a tulip bulb, but if you hope to sell it on to another receptive buyer for $2m, it can still be a rational investment. This is known as the "greater fool" theory.

Whether or not it explains tulip mania however, is a subtle question.

Charles Mackay's 1841 account of tulip mania has cast a long shadow over our imagination.



His book, ‘Extraordinary Popular Delusions And The Madness of Crowds’, is full of vivid stories about how the entire Dutch nation was involved.

But those extravagant tales - including the one I have just told you, about the hungry sailor - could well be not quite as vivid as the picture he paints in his book.

Tulips were part of a cornucopia of new plants to arrive in Europe in the 1500’s, including potatoes, green and red peppers, tomatoes, Jerusalem artichokes, French beans and runner beans.

At first, tulip bulbs were sufficiently unfamiliar to be mistaken for vegetables. On at least one occasion, someone roasted them with oil and vinegar – perhaps this is the kernel of truth in Charles Mackay's tall tale.

But once it became clear what to do with them, everyone began waxing lyrical about their beauty.

And by the early 1600’s, the price of tulips just kept on rising.

Of course, the idea that some poor fellow had his million-dollar tulip bulb consumed with a herring over breakfast may be fanciful – but the idea that a tulip bulb could really be worth a million dollars? It's not quite as absurd as it might seem.

In early 1637, a single tulip bulb could be worth as much as 4,000 or even 5,500 florins - since the 1630's florins were gold coins of uncertain weight and quality it is hard to make an accurate estimation of today's value, but (using USD as an example) there are some points of reference…

Now I’m a committed craft beer drinker, so this particular example was right in my beer glass of knowledge!

Among other things, 4 tuns of beer cost 32 florins. That's around 1,008 gallons of beer - or 65 kegs of beer. A keg of Deschutes Fresh-Squeezed IPA costs around $106, and so 4 tuns of beer = $5,712 and 1 florin = $176.

That means that the best of tulips cost upwards of $880,000 in today's money!

Another thing to consider is that tulip bulbs produce not only tulips, but offshoot bulbs called offsets.

Owning a rare bulb was a bit like owning a champion racehorse: valuable in its own right, perhaps, but far more valuable because of its potential offspring.

Given how far the wealthy would go to possess unusual tulips, there was nothing foolish about bulb traders paying top dollar (maybe we should say guilder or florin) for the bulbs.

Financial bubbles burst when expectations reach a tipping point: once enough people expect prices to fall, the supply of greater fools dries up. Does that explain the sudden collapse in prices in February 1637? Perhaps.

But there's another theory…

A default on a tulip bulb contract by a buyer in Haarlem was the main bubble-popping catalyst and caused the tulip bulb market to violently implode as sellers overwhelmed the market and buyers virtually disappeared altogether.

Some traders attempted to support prices, to no avail. Within just a few days, tulip bulbs were worth only a hundredth of their former prices, resulting in a full-blown panic throughout Holland. Dealers refused to honor contracts, further damaging confidence in the tulip bulb market.

Eventually, the government attempted to stem the tulip market meltdown by offering to honour contracts at 10% of their face value, which only caused the market to plunge even further. The brutal popping of the tulip bulb bubble ended the Dutch Golden Age and hurled the country into a mild economic depression that lasted for several years.

By the way - Haarlem is one of the warmer Dutch cities and February is exactly when tulip shoots would have burst through the soil.

Having seen abundant shoots on their journeys, the bulb traders might have realised that the crop would be bountiful, and the rare flowers rather less rare than they had imagined.

If so, the fall in prices may have reflected an increase in supply, rather than the bursting of a bubble - However, we will probably never know.

Right now, it's Covid-19 causing stock market mayhem. But in the past we've had dotcom stocks, the 1929 crash, 19th-century railways and the South Sea Bubble of 1720. All these have been compared by contemporaries to "tulip mania", the Dutch financial craze for tulip bulbs in the 1630s.

Why this lasting fixation on tulip mania? It certainly makes an enticing story, one that has become a byword for insanity in stock markets.

It has also been incorporated into the public discourse as a moral lesson, that greed is bad and chasing prices can be dangerous.

It has become a fable about morality and markets, invoked as a reminder that what goes up must come down again.

Moreover, the Church latched on to this tale as a warning against the sins of greed and avarice - it became not only a cultural parable, but also a religious one too.

What can we learn?

Well, ‘stuff happens’, but on every occasion the financial markets have not only recovered, but gone on to even greater heights.

My advice is: Don’t be ‘The Greater Fool’ during this difficult time. The key is holding your nerve when ‘stuff happens’, not going into panic mode and keeping focus on your longer term financial goals - Why?

Because stock history also tells us that what goes down will bounce back up again.