TULIPMANIA & ECONOMIC BUBBLES

THROUGHOUT HISTORY, MANY ECONOMIC BUBBLES HAVE OCCURRED. THE RECENT HOUSING BUBBLE, FOR EXAMPLE, GREATLY DAMAGED OUR ECONOMY. THE FIRST MODERN BUBBLE WAS DUTCH TULIPMANIA, WHEN AT THE BUBBLE'S PEAK IN 1637, TRADERS WERE PAYING THOUSANDS OF DOLLARS FOR A SINGLE TULIP BULB.

Tulips grew wild in Central Asia. By the early 1500s, Turks were cultivating "the flower of God" in the Ottoman Empire. Hundreds of varieties emerged, many with beautiful colors and shapes.

The flower grows from a tulip bulb. New multiple colors, showy markings, and unusual petal shapes sometimes occur on a flower. The rarest tulip flowers display spectacular markings of "flames" or "flares."

The brilliance and unpredictability of tulips caught the attention of European flower collectors. The first tulips reached the Dutch Republic in 1562.

The most important Dutch province was Holland, with its major seaport of Amsterdam. Holland grew into the center of a rich Dutch commercial empire that stretched from Asia to the Americas. In the 1600s, its trading ships outnumbered those of all other European countries combined.

Holland excelled at the spice trade, shipbuilding, cloth manufacturing, and banking. Amsterdam had its own active stock exchange. While the rest of Europe stagnated in feudalism, the Dutch Republic entered its Golden Age and became a pioneer in modern capitalism.

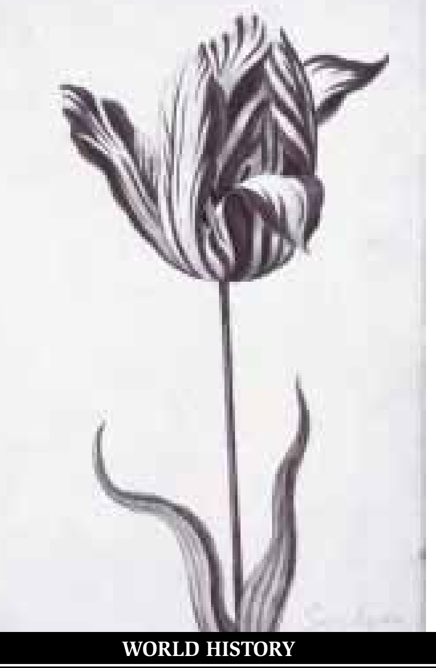
As many Dutch merchants became rich, they looked for ways to enjoy their new wealth. They built grand houses, hired artists to paint their portraits, and collected things like tulips.

The Tulip Bubble

Tulip trading became a fad among rich Dutch merchants. They bought and sold tulip bulbs among themselves, planted them in September, and anxiously awaited their blooms in April and May. They collected tulips as they did works of art, to enjoy their beauty and rarity.

For years, only wealthy Dutch merchants traded tulips. But in the 1630s, tulips became fashionable in France. With a developing export market for tulip bulbs and the continuing demand from collectors, other well-off Dutch merchants saw a chance to get rich in the tulip trade. These tulip bulb traders, called "florists," were only interested in making a profit. They never intended to grow the beautiful flowers.

The Dutch tulip business expanded. Growers opened new gardens to produce the highly desired bulbs. Soon, the profit-minded florists were buying and selling tulip bulbs at ever-higher prices, especially for the rare varieties.



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The first economic bubble in modern capitalism began to inflate. Economic bubbles occur when buyers and sellers rapidly drive up the price of some asset, like stocks, houses, or even tulip bulbs, far beyond their apparent worth.

Tulip trading took place in the summer. Collectors bought and sold individual tulips among themselves when the bulbs were lifted from the ground and dried to prevent rotting. The speculating florists not only traded by the bulb, but also by a bulb's weight.

The florists hated that they could only trade in the summer. By 1636, they created a special written contract for buying and selling in the wintertime when the bulbs were planted underground. For example, in December, a tulip grower might agree to sell a particular bulb for 500 guilders (a Dutch unit of gold money) when it was lifted after blooming in the spring. The buyer was betting that by then the tulip would be selling for more, say 700 guilders, on the open market. He would pay the grower 500 guilders and make a nice profit of 200 guilders.

This was an odd contract. When the deal was made in December, the seller did not have the bulb in hand, and the buyer usually did not pay him any money. The actual exchange of bulb for guilders would occur in the future, in the summer after the bulb had bloomed and been lifted. Today, we call this kind of agreement a "futures contract."

The florists usually conducted their futures trading in taverns. They formed organizations called "colleges" to oversee their auctions. Members of these tavern colleges not only bid on actual bulbs, but also bought and sold futures contracts.

In the winter of 1636–37, bidding in the taverns reached a frenzy. The prices of individual tulip bulbs rose to incredible levels. On February 5, a public tulip bulb auction took place ➤

in Alkmaar, Holland. One bulb sold for 4,203 guilders (roughly $50,000 in today's purchasing power). The entire collection of 124 bulbs (still in the ground) sold for a total of 90,000 guilders, equal to about $1 million today. This was the bubble's peak.

On the same day as the Alkmaar auction, Haarlem florists 15 miles away were having second thoughts about the high bidding. If they bid high prices for bulbs, they would have to find people in the spring who would pay even higher prices. It dawned on them that this was unlikely. Suddenly, bulb demand dropped in the tavern colleges, prices collapsed, and the tulip bubble popped. Panic spread among the florists in other towns.

Futures contracts were always risky. If a contract called for a buyer to pay a seller 500 guilders for a bulb at lifting time but the market price for it had dropped to 200 guilders, the buyer still owed the seller 500 guilders. The buyer would have to take a loss of 300 guilders. This situation repeated itself among the florists as tulip prices crashed.

If the buyer did not have the money to pay his obligation, the seller could keep his bulb and sell it for the depressed market price. But he would feel cheated. The buyer had promised to pay him the full agreed price.

When the price of bulbs collapsed, many sellers went to court, demanding the buyers pay what they agreed to pay. But the Dutch Republic had passed laws banning futures contracts, and the courts refused to enforce them. The sellers turned to the Dutch government, but it refused to take action and referred the issue to the town governments. The problem of what to do about the futures contracts remained at a standstill until a year later when the Haarlem city council ruled that buyers could cancel their contracts by paying 3.5 percent of the original contract's sale price. The seller would get this money and keep ownership of the bulbs. Most other Dutch towns adopted this compromise. By 1639, the tulip bubble crisis was over.

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TRADERS MILL ABOUT the floor of the New York Stock Exchange, c. 1930s.

Tulipmania was the first major economic bubble in modern capitalism. Because it was limited in scope, it did not cause a great deal of economic damage. Other bubbles have proved far more devastating.

Mississippi and South Sea Bubbles

In 1717, John Law, a Scottish financier, gained the confidence of the debt-ridden French royal government. It let him set up a bank and the Mississippi Company. It granted the company a monopoly on trade between France and its colonies of Louisiana and Canada, connected by the Mississippi River.

Law promised the royal government he could stimulate commerce and end the national debt. His bank would print paper money and his Mississippi Company would develop trade, especially with Louisiana, which he described as rich in gold and silver.

Law offered to pay government debt holders with shares of his Mississippi Company. He also sold shares to investors.

The lure of Louisiana gold and silver drew many investors. At one point, soldiers had to maintain order in the stock exchange as investors fought over buying shares. The share price rose by almost 200 percent in 1719. Even poor working class people tried to scrape together money to buy shares. The French invented a new word, "millionaire," to describe the big buyers and sellers of Mississippi stock.

Then, the Mississippi Bubble popped. Investors began to take profits by cashing in their shares for gold coin. Law attempted to keep share prices up by printing more paper money and using it to buy stock. But this led to uncontrolled national inflation, especially harming the poor who had to pay more for food and other necessities.

In 1720, share prices dropped to almost nothing. Thousands of investors, poor and millionaires alike, were ruined. The French economy fell into a depression for several years.

At the same time in England, another bubble developed. The South Sea Company got the exclusive right to trade with Spanish South America (then called the South Seas). The company and English government persuaded many government debt holders to exchange their bonds for stock in the trading company.

The company's directors spread rumors about the rich trade with South America, although this turned out to be only one commercial ship per year plus some slave ships. The rumors sparked a speculating frenzy among all classes of people from common workers to lords and politicians.

When profit-takers started selling shares in the company, however, the prices dropped. News of the Mississippi Bubble crash in France sped up the South Sea Bubble collapse. Widespread economic distress occurred in the country.

1929 Stock Market Bubble

Another major bubble occurred in the 1920s when speculation in stocks took off. As the stock market rose, hundreds of thousands of ordinary Americans invested heavily in it. They believed the rise in share prices would never end.

To keep up with the other investors who were getting rich quick, many bought stock "on margin." An investor would pay a stockbroker a portion of a stock's price and borrow the rest from the broker. When the stock increased in price, the investor would sell it, pay off the loan from the broker, and keep the rest as profit. Eventually, investors were borrowing up to 90 percent of a stock's price from their brokers.

Investors kept buying stocks. Few bothered to worry that many companies' actual earnings and profits did not justify their high stock prices.

In an attempt to tamp down speculation on Wall Street, the Federal Reserve increased interest on loans. This also made it more difficult for businesses to borrow, which slowed down the economy. In summer 1929, a decline in construction and car sales warned that a business cycle recession might be on the way. But the party on Wall Street continued.

Finally, in October 1929, stock market prices began to slip and then drop sharply. On October 29, panic selling hit the New York Stock Exchange. On "Black Tuesday," the value of stocks dropped by millions of dollars.

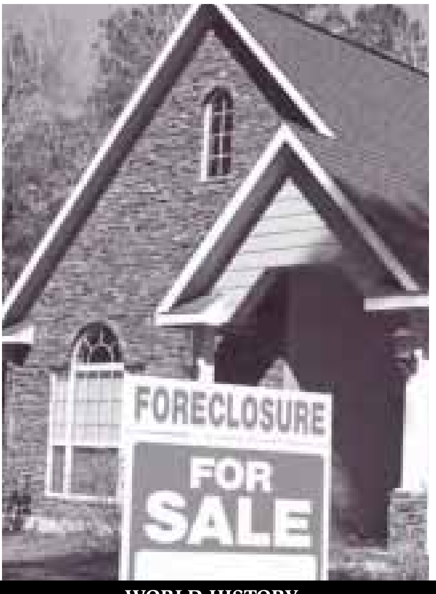
Stock investors who did not sell soon enough lost money. Those who still owed their stockbrokers for "on margin" loans found themselves in worse economic trouble. For the U.S. economy, the 1929 stock market crash signaled the beginning of the Great Depression.

U.S. Housing Bubble

The United States has experienced two recent bubbles. In the late 1990s, the dot-com bubble began. Many new Internet start-up companies attracted investors who saw the Internet's promise. Even though companies produced no income, more people invested, and their stock prices soared. In 2000, the bubble burst, many Internet companies went out of business, and investors lost their money.

The second bubble also began in the 1990s. Low interest rates for borrowing fueled a boom in U.S. house buying and construction. Home prices doubled and even tripled in parts of the country.

Seculators bought and sold homes for astonishing profits. A TV show even focused on "house-flipping." But the big driver of the housing bubble was the lending industry. Eager to make money in the red-hot real estate market, banks and other lending companies made it too easy for people to buy houses that they could not afford. In many cases, lenders approved home loans with little or no down payment and never checked the buyers' income.



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Millions of otherwise unqualified home buyers entered the housing market. Housing prices kept going up, and many believed they would keep going up.

Many lenders pushed buyers to sign new types of risky loans called "subprime mortgages." A homeowner might pay only a low interest rate for a few years and then face an interest "reset." Some homeowners would enter these agreements because they didn't understand them. Others believed they could always sell their house for a profit. Still others thought interest rates would fall.

When the loans were reset, however, many homeowners found that they did not have enough income to pay the monthly mortgage. The only alternative for these distressed homeowners was to sell their houses, hoping to pay off their mortgage debt. But as thousands and then millions of homeowners across the country tried to sell their houses, real estate prices plunged, and the housing bubble burst in 2007. Millions found themselves "underwater," owing more for their homes than they could get by selling them.

Many banks and lending companies that held subprime mortgages failed when homeowners could not pay their mortgages. In many cases, however, the original lenders had bundled these risky loans and sold them to big banks and Wall Street investment companies. They, in turn, resold them as investments to other U.S. and foreign financial organizations. After the housing bubble burst, they also were at risk, holding trillions of dollars worth of dead loans.

The U.S. housing bubble led to a collapse in housing prices and construction along with a financial crisis. Frightened consumers, burdened with debt and homes that had lost much of their value, cut back on spending. Businesses laid off workers, and the Great Recession began. ➤

FOR DISCUSSION AND WRITING

1. What is a bubble?

2. How are the tulip, Mississippi, and housing bubbles different from one another. How are they similar?

3. Both the Bush and Obama administrations passed laws to help subprime mortgage borrowers renegotiate their loans, which would then be backed by the federal government. These laws were aimed at keeping people in their homes. Some oppose this help for people whose bad judgment led them to buy houses they could not afford. What do you think?

ACTIVITY

What Can Be Done to Prevent Bubbles?

In July 2010, President Barack Obama signed a financial reform act into law, ending a long period of financial deregulation beginning in the 1980s. Among other things, the new law:

- Expands banking regulations beyond banks to other financial companies.
- Gives federal regulators the power to control and even shut down troubled companies.
- Creates a new office to protect consumers of financial products. One thing it will do is create a short, clear mortgage form so that home buyers can understand their loans.

The law contains many other regulations on banks and financial instruments.

Two questions: Do you think that regulations can prevent or alleviate bubbles and the problems they cause? Or do you think that bubbles are natural to capitalism and we should just let the market run its course?

In small groups, discuss these questions, decide on your answers, and prepare to report your answers and reasons to the rest of the class.

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