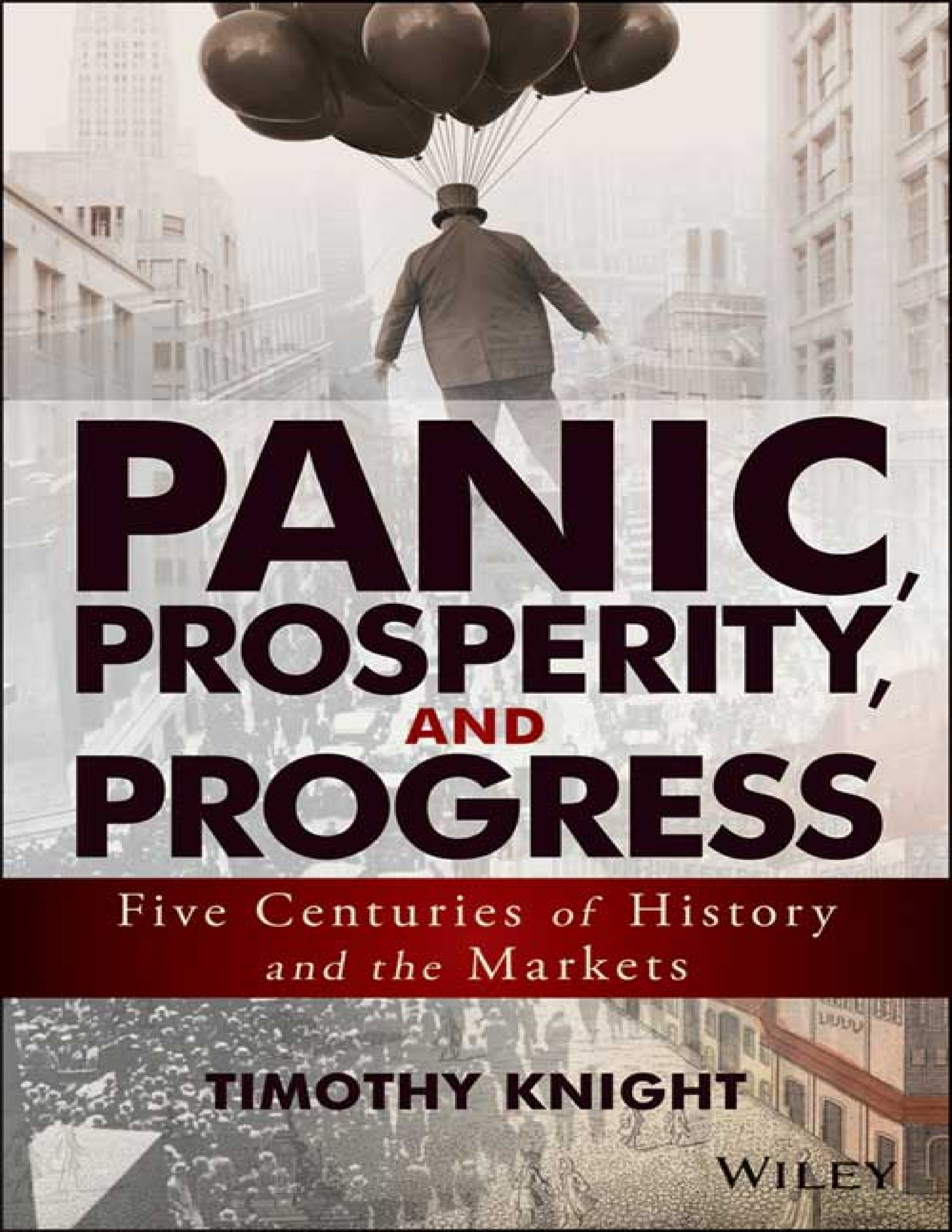

PANIC, PROSPERITY, AND PROGRESS

Five Centuries *of* History *and the* Markets

TIMOTHY KNIGHT

WILEY

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This book is dedicated to Lee Barba, a fellow historian and student of the markets. Thank you for taking the risk that others lacked the courage to take.

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PREFACE

As I suspect the case is with many others, my interest in history did not reveal itself until long after my formal education was complete. A school's offering of dates, places, and long-forgotten names captures the interest of very few children, and unfortunately it usually snuffs out any latent desire they might have to explore tales of the past that can offer up wisdom, insight, and previously unseen linkages.

For most of my adult life, I have had a deep and abiding interest in two related subject areas: history and financial markets. While the two might seem to be only obliquely related, they are actually engaged in a constant dance, with one informing the actions of the other. Historical events move currencies, stocks, debt, and all other flavors of fiscal instrument, and likewise movements—particularly exaggerated movements—in the financial markets can drive the decisions that shape history in real time.

When I first developed the outline of this book, I tried to gather up what I suspected were the most interesting and market-moving developments of the modern age. To my surprise, some of the events that I thought would have a major impact (such as the Kennedy assassination in 1963 or the London subway bombing of 2005) were, as far as financial markets were concerned, virtually immaterial; it was if they had never even happened. However, other topics I had initially left out, such as the Russian debt crisis of 1998, turned out to be monumentally important.

The completed book you are holding contains two dozen chapters of what I consider the most interesting and important episodes over five centuries that have had an impact on the thinking and behavior of financial markets. There are manias, panics, battles with inflation, the travails of war, and stories of riches both won and lost. The tales extend from early seventeenth-century Holland up to the twenty-first-century United States.

My hope is that, having read these accounts, the reader can gain perspective—specifically, perspective of how consistent human behavior has been over the centuries, and how in spite of extraordinary technological, political, and legal changes, the templates that govern humanity's relationship with both opportunity and fear are surprisingly steady.

There will undoubtedly be new "chapters" in your own lifetime of globally important events that move both markets and sentiment. In the end, I hope the reader can be better armed to comprehend the world's complexities and changes by way of the knowledge and insights this book endeavors to provide.

Tim Knight
Palo Alto, California
August 1, 2013

CHAPTER 1

Tulip Madness

In popular culture, there is probably no better-known event in the lexicon of unusual financial history than the tulipmania that seized Holland in the early seventeenth century. Whenever there is a financial bubble in modern times, the term *tulipmania* is bandied about, but few commentators who use the term have a grasp as to what actual events occurred.

It is a fascinating tale—perhaps somewhat apocryphal—and, if nothing else, entertaining. And it is surely the only chapter in this compendium of financial history that involves not one but two important biological maladies that shaped the story: a flower-distorting virus and a deadly human plague.

An Introduction to the Flower in Question

If you've ever grown tulips, you know all too well that, while beautiful, the tulip is a temperamental and relatively weak plant whose bloom is short-lived and whose likelihood of returning the next year is far from certain.

The flower itself was unknown to most of Europe in the sixteenth century, but around 1554, the Pope's ambassador to the Sultan of Turkey was charmed by the flower and collected seeds and bulbs for distribution. (The word *tulip* itself is said to be derived from the Turkish word for "turban," since the bloom somewhat resembles the same).

Cultivation spread throughout the region we today call the Netherlands as tulip bulbs found their way to Vienna, Antwerp, and Amsterdam. Planters took pleasure in the vibrant blooms and the fact that the plants were more tolerant of the harsher climate of the lower countries.

The bulbs themselves were classified into three groups: the single-colored, the multicolored, and the "bizarres." This last category is most germane to the tale of tulipmania, as *bizarres* were the rarest and most sought-after tulip. The reason these unusual flowers came about was a virus that interfered with the plant's ability to create a uniform color on the petal. It is today known as a "breaking" virus, since it breaks the plant's lock on a single petal color, although it does not kill the plant itself. The effect on the flower was striking, producing mosaic-like flames of color on each petal.

Even regular, single-colored tulips are difficult to grow from seeds. It took anywhere from 7 to 12 years to produce a flowering bulb from a seed, and once the bulb was at long last established, it would create only one or two clones (or "offsets") in a given year. The mother bulb itself would last only a few years before it died.

As challenging as it was to propagate *regular* tulips, it was even harder to do so for the exotic varieties, since the virus weakened the plant somewhat, and it usually failed to create offsets, meaning that any bizarre varieties required new plants be created from seeds. The length of time required for that growth meant that the most appealing varieties of tulips remained rare.

As knowledge of tulips spread, collectors of the bulbs began to give the exotic varieties inventive names such as "Admiral" and "General" to suggest the boldness of the plant's appearance. A sort of one-upmanship developed with the naming, leading to exalted titles like "Admiral of Admirals" and "General of Generals." For years, the cultivation and selling of tulip bulbs was little more than a curious hobby among horticulturists and the well-to-do.

Rise of the Tulip

As the sixteenth century turned over to the seventeenth, Holland was on the ascent. The area, formerly known as the Spanish Netherlands, had won its independence. Amsterdam, the capital of Holland, found itself as the driving force behind commerce, particularly as a trading partner with the East Indies. Newfound wealth and prosperity flooded the region, with single trading voyages yielding profits upwards of 400 percent to the financiers backing them.

A merchant class arose, and the new money in the area sought ways to show off its wealth. Grand estates begin springing up around Amsterdam, and nothing framed a handsome home better than a vibrant display of flowers in the surrounding gardens.

And, naturally, there were precious few flowers more showy and eye-catching than the tulip.

The tulip's reputation was on the rise, and by 1634, anyone with money but without tulips was judged simply to have bad taste. Whereas tulip bulbs used to be sold by the pound, their rising popularity and prices made them exponentially more precious, and soon much tinier weights were used as the basis of the tulip trade. A concurrent demand from French speculators for the bulbs only pushed the price higher.

The trading of the bulbs was framed by the growing season of the flowers themselves. Tulips bloom in the springtime for just a few weeks, and they enter a dormant phase from June through September. It is at this time they can be safely uprooted and moved about, so actual physical trades took place around this time of the year.

Because speculators did not want to confine their trading to just a few months, they put together what could be considered a futures market. Two traders could sign a contract in front of a notary, pledging to buy a certain quantity, type, and quality of bulb at the end of the season for a certain price. These contracts soon found an aftermarket of their own, so that people begin trading the paper instead of the physical bulbs.

Market Frenzy

In 1636, the tulip bulb was the fourth leading export of Holland (if you are curious, the leading three were gin, herring, and cheese). Because the margin requirements for tulip futures were minimal, the price of the contracts began to soar spectacularly. Some historians have noted that, due to the presence of the bubonic plague at the time, some individuals viewed life quite fatalistically, leading some speculators to trade with complete imprudence.

The Calvinists of Amsterdam viewed with dismay and concern the speculative frenzy that was springing up in their native land. The virtues of discretion, moderation, and hard work seemed to be shoved aside for the easy profits of trading in paper. The appeal of the profits at the time was understandable, however, as prices lurched forward. By 1637, a single bulb could fetch the equivalent of 10 years' salary of a skilled craftsman. Entire estates—one reported to be a full 12 acres—could be had for a single exotic "bizarre" bulb.

One of these bulbs, named the *Semper Augustus* (see Figure 1.1), was particularly coveted. In 1636, there were only two such bulbs in all of Holland. As trading spread throughout the country, it became impractical for speculators to make the trip to Amsterdam, so smaller exchanges appeared in the taverns of small towns using similar trading rules as had been established in the capital city. To create an atmosphere of prosperity and opulence, these taverns were often adorned with large vases of tulips in full bloom and sumptuous dinners that traders could enjoy while doing their business.

FIGURE 1.1 *Semper Augustus* was one of the most-prized varieties of tulip.

The final spasm of buying was promulgated by a decision made in February 1637 by the self-regulating guild of Dutch florists. They agreed that, by their new rules, all the futures contracts that had been put in place since November 30, 1636, could henceforth be considered options contracts. This wasn't the exact language they used, of course, since such terms for financial instruments did not exist, but the effect was the same.

The difference between a futures contract and an options contract is subtle but crucial: with a futures contract, the buyer agreed to buy a certain quantity of a product at a certain price on a certain date; the obligation to buy was firm. With an options contract, the buyer had the right—but not the *obligation*—to execute a purchase based on the same terms.

To cite an example, if a person bought an option contract when the underlying asset had a value of 500, and the asset's value went to 800 by the expiration date of the contract, the buyer would presumably be glad to honor the terms of the agreement and purchase the product at 500 (since the market price was already up 60 percent). However, if the price had dropped to 250, the buyer could simply let the contract expire, losing only a small transaction fee equivalent to about 3.5 percent of the contract price.

With this new rule proposed, which the Dutch Parliament ratified, the risk of engaging in these contracts to the buyers decreased dramatically (indeed, by 96.5 percent). The reason is that those trading in tulip futures now bore very little risk, since they could simply walk away from the agreement if prices didn't behave favorably. If tulips ascended in price, the speculators made a lot of money. If the tulips fell in price, speculators lost only a small amount of risk capital.

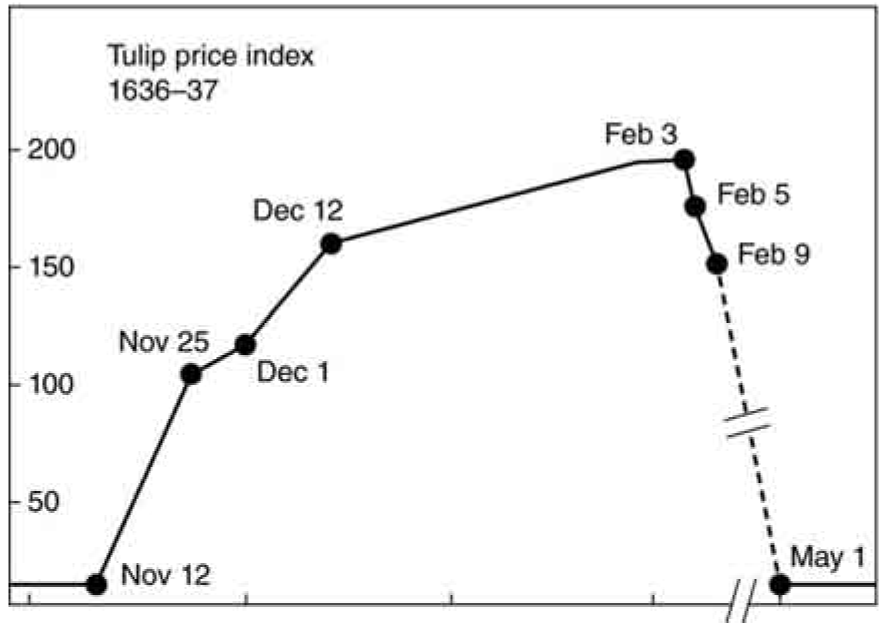
It was at this time that trading reached its peak, in terms of both price and volume. Some bulb agreements changed hands 10 times in a single day.

The market finally broke down during a routine bulb auction held in Haarlem, Holland. A mass of sellers showed up to conduct business, but there wasn't a single buyer to be found. Some believe a severe outbreak of the bubonic plague kept the buyers away (although it seems to have done nothing to deter the *sellers*), but the simple fact is that the normal spot market for bulbs was suddenly one-sided and thus nonexistent. All sellers and no buyers does not a market make.

Within days, panic spread across the country, as people soon realized that their enormous trading profits were no more valuable than the paper on which the agreements were written (see Figure 1.2).

FIGURE 1.2 After peaking in early February, tulip prices crashed hard, erasing the entirety of prior gains.

Source: Used with permission from Jay Henry.



The Bloom Is off the Rose

The crash in tulip prices was even more rapid than the ascent. One bulb that had risen in price 26-fold by January 1637 lost 95 percent of its value in just one week. Speculators around the nation were facing losses that were in some cases ruinous.

Citizens demanded that their government do something about it, so the matter was referred to the Provincial Council of The Hague. After three months of discussion and debate, the Council made their announcement, which was this: they *had* no decision, and they would need more information. Not surprisingly, this provided cold comfort to the distressed populace.

The Council's follow-up suggestion wasn't much more helpful: they advised that every seller should meet with each corresponding buyer and, in front of witnesses, offer the tulips to the purchaser for the previously agreed price. If the buyer refused to complete the deal, the tulips could be put up for sale in a public auction, and the buyer would be held responsible for the difference in price.

In a market that had lost virtually its entire peak valuation, this was obviously a bad situation for buyers and sellers alike (but significantly worse for the sellers, who were stuck with bulbs that now weren't worth much more than onions).

There was no legal recourse to be had, either. The judges in Holland considered all the financial agreements pertaining to the tulip frenzy to be nothing more than gambling debts and, as such, were unrecognized by the legal system. Even if buyers were deemed responsible for the agreed-upon payments to sellers, those sums were unenforceable, and thus everyone who owed money simply ignored the entire matter.

As a final effort to shore up the badly rattled economy, the government offered to void any existing contracts for a fee equal to 10 percent of the contract price. Because prices had already plunged even more than 90 percent, this offer likewise provided no meaningful relief. In the end, most participants in the tulip madness suffered economic hardship, and the psychological scars would be with the nation for decades to come.

The Compost Heap

The events surrounding Holland's tulipmania have become the stuff of financial legend to this day, but modern historians speculate that perhaps the magnitude of the event was much smaller than some believe. Although there was indeed enthusiastic trading of tulip bulbs around 1636, it may have been confined to a very small number of merchants and craftsman, who for a time wanted to ape the exciting high-finance behavior of the nobility.

Some of the famous stories related to this time seem hard to believe. One oft-cited tale is of a sailor who, hungry while visiting a friend, plucked up a tulip bulb from his friend's table (thinking it was an onion), slipped it into his pocket, and boiled and ate it later. Once discovered, the poor sailor was pursued, captured, and thrown into jail for consuming a bulb whose value was equal to all the food the entire crew on the sailor's ship would require for a year.

Setting aside the fact that a tulip bulb bears little resemblance to an onion, eating a tulip bulb would be a wholly unappealing experience. The taste would be terrible, and even if the fellow managed to choke it down, the effects on his body would have been toxic. It seems a story such as this is more of an invention of propaganda than an account of an actual event.

The Dutch lunacy spread somewhat beyond its borders, creating miniature tulip frenzies in London and France, but attempts by brokers to push tulip prices to the levels seen in Amsterdam met with only moderate success. Even if the tale of flower-bulb speculation from long-ago Holland is more fiction than fact, it still is a fascinating anecdote into how the novelty of a new product (in this case, a flower, as opposed to an iPhone) can capture the public's imagination, if only for a few months (see Figure 1.3).

FIGURE 1.3 Jan Breughel's famed *The Folly of Tulip Mania*, painted in 1640 and displayed at the Frans Hals museum in Haarlem.

CHAPTER 2

The Mississippi Scheme

It seems hard to believe that an obscure Scotsman born over 350 years ago would have profound effects that persist in the financial world to this day, but it is true, and that man's name was John Law. The events surrounding Law's actions in the eighteenth century are the stuff of legend, and Law is considered by some economists to be the world's first Keynesian—that is, a person who supports the notion that flooding an economy with government spending is the best way to address a weak economy. Even the everyday English word *millionaire* was coined during the mania of Law and his so-called Mississippi Scheme. In this chapter, we will explore what led up to the scheme, its construction, and the devastation it wrought.

Law's Early Life

John Law was born in Edinburg, Scotland, in 1671. He was the oldest son of a banker, and as was the custom at the time, young Law apprenticed in his father's business beginning at the age of 14. For three years he worked in his father's counting house, learning the principles of banking.

In spite of being in a family of bankers and goldsmiths, Law did not have a passion for the business, and after his father died in 1688, the young Law took the opportunity to leave the family enterprise for an activity with far greater personal appeal: gambling. He set out for London and tried to apply his knowledge of statistics and probabilities to forge success as a professional gambler.

He did quite well for a while, managing to live a life of pleasure, pursuing his passion, but after nine years, Lady Luck began to neglect Law, and he lost more money than he could repay.

Law's plight was soon to exceed that of a mere gambling debt. He was quite taken with a lovely young woman named Elizabeth, and a suitor of hers, one Edward Wilson, didn't take kindly to the competition. Wilson challenged Law to a duel, which was unfortunate on his part, because Law shot him dead with a single shot.

Duels were a widespread custom in the eighteenth century, but they were not part of the actual rules of society, so Law was arrested and charged with murder. He soon stood trial at the Old Bailey before a judge who was known as a sadistic "hanging" judge who had no compunction about handing down stiff sentences to criminals. True to form, the judge sentenced Law to death after he was found guilty of murder.

Happily for Law, and for our story, his sentence was commuted to a fine, based on a decision that the killing was manslaughter and not murder. Wilson's brother was outraged and, while Law was still imprisoned, sought to have a harsher punishment foisted on his brother's killer. Law, however, managed to escape from prison and reached the continent of Europe, far away from London judges and grieving brothers.

On the European continent, Law resumed his gambling, spending three years both trying to earn a living and studying the monetary and banking affairs of the various countries he visited. The middle of the eighteenth century was an exciting, dynamic time for Europe, full of new ideas about science, the economy, and social experiments, and Law's penchant for numbers and knowledge of banking made him a quick study.

Franco Finances

The currency of old France was known as the *livre tournois.* The livre was originally established by Charlemagne as a unit of account equal to a pound of silver, and it was divided into 20 parts (called *sous*), which itself was further divided into 12 parts (*deniers*). (*Note:* To make reading and understanding the events in this chapter easier, I'll refer to the unit of currency as the *dollar,* although that is not the historically-accurate term.)

In the early 1700s, the French economy was a mess. King Louis XIV (see Figure 2.1) had waged a number of wars that left his country a financial basket case, and the country was at the brink of financial ruin. The national debt was about $3 billion, and the wealth of the nation (largely in the form of precious metals) was mostly spent. Indeed, the shortage of precious metals meant that not enough money was in circulation.

FIGURE 2.1 Louis XIV, King of France, by the French engraver and artist Robert Nanteuil.

Source: Yale University Art Gallery.

Using the metaphorical image of the French economy as a body, the blood flowing within that body (in this case, gold and silver) had been largely drained away, so the body's health was in great danger. There simply wasn't enough blood to go around, since it had been spilled for unproductive wars.

It's important to know that during the course of Law's travels, he had become friends with the Duke of Orléans, who was the nephew of King Louis XIV. Although Law could not have foreseen the value of this friendship in years to come, being close to a royal family member usually isn't a bad connection to have.

Second, in spite of the shambles of the French economy, France did hold a vast expanse of territory in North America surrounding the Mississippi River known as Louisiana (of course, this territory was far greater in size than the state of Louisiana