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Behavioral Insights into Financial Crises: Tulip Mania, the Great Depression, and 2008

Weiheng Xue

Changsha Meiben Xingchen Education, Changsha, China
b11112042@office365.npust.edu.tw

Abstract. Financial crises have repeatedly devastated economies, prompting a search for deeper explanations beyond traditional finance. Episodes from the 17th-century Dutch Tulip Mania to the 2008 global meltdown reveal patterns of speculative bubbles and crashes that classical theories struggle to explain. This paper, based on relevant theories from behavioral economics and adopting a case-study approach, focuses on herd behavior, overconfidence, heuristics, and loss aversion to analyze three historic crises (1637 Tulip Mania, 1929 Wall Street Crash, 2008 Global Financial Crisis). In each case, psychological factors proved pivotal. During booms, widespread overconfidence and herd mentality fueled asset-price bubbles, as investors irrationally extrapolated recent gains and ignored fundamental risks. At the tipping point, these same forces flipped to fear: herding in reverse as panicked sell-offs ensued, with loss aversion driving investors to liquidate at any price. The analysis presented in this paper finds that collective euphoria and panic—rather than purely rational responses—largely triggered the collapse of each bubble. These findings underscore the significance of behavioral biases in financial crises. Recognizing and mitigating such biases is crucial for economists and policymakers seeking to prevent future bubbles and cushion market collapses.

Keywords: Tulip Mania, 1929 Wall Street Crash, 2008 Global Financial Crisis

1. Introduction

1.1. Research background and motivation

Financial crises have been a recurring phenomenon throughout history, from early market bubbles to modern banking collapses. Such crises—often involving a frenzy of speculative investment followed by a sudden crash—can inflict severe economic damage, as seen in the Great Depression of the 1930s and the global recession after 2008. Understanding why these dramatic boom-bust cycles happen is of great importance. Traditional economic theory long assumed that investors are rational and markets efficient, an assumption that struggles to explain the irrational exuberance and panic selling often observed in real crises. This gap motivates the use of behavioral economics, which examines how human psychology and biases deviate from perfect rationality. By exploring crises through a behavioral lens, this article gains insight into how emotions and cognitive errors can destabilize markets—a perspective that is increasingly seen as essential for improving financial

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stability. Indeed, historical evidence shows that financial manias and crashes have occurred repeatedly over the centuries, suggesting that understanding investor behavior is key to preventing the 'this time is different' syndrome [1].

1.2. Literature review

The literature on financial crises offers diverse viewpoints and debates. One perspective highlights real economic fundamentals and policy failures as primary causes. A monetary-history study argues that the Great Depression was triggered and worsened by monetary contraction and central-bank mistakes, rather than by investor psychology [2]. Another historical analysis documents how manias —periods of rampant asset inflation driven by easy credit and optimism—are regularly followed by panics and crashes when confidence evaporates [3]. In a related vein, the financial-instability hypothesis posits that prolonged prosperity breeds complacency and risky leverage, so that economic stability itself destabilizes: investors take on ever-greater debt in euphoric times until the financial system tips into crisis when euphoria turns to fear [4]. Not all scholars agree that bubbles stem from irrationality, however. Adherents of efficient-market theory maintain that asset prices generally reflect fundamentals, implying that true bubbles are rare anomalies or driven by rational expectations [5]. Another argument suggests that famous 'bubbles' contained rational elements; for instance, the 1630s Tulip Mania can partly be explained by real prospects for new tulip-bulb varieties, rather than pure folly [6]. In contrast to these rationalist views, behavioral research emphasizes the role of psychology. The concept of 'irrational exuberance' highlights how investor enthusiasm can inflate prices far beyond intrinsic value [7]. Similarly, the animal-spirits framework argues that stories, confidence, and herd behavior often drive economic booms and busts independent of fundamentals [8]. These differing perspectives underscore the need to integrate psychological factors into the understanding of financial crises, as purely economic or policy-based explanations do not fully capture the extreme swings in investor sentiment observed during major collapses.

1.3. Research contents

This paper, grounded in behavioral-economics theory and adopting a multiple-case analytical method, analyzes three landmark financial crises: the Dutch Tulip Mania of 1637, the U.S. stock-market crash of 1929 that led to the Great Depression, and the Global Financial Crisis of 2008. For each case, a pivotal triggering event that precipitated the market collapse is identified and examined. The paper then interprets the lead-up and aftermath of that event through four key behavioral lenses —herd behavior (the tendency of individuals to follow the crowd), overconfidence (excessive optimism in beliefs or forecasts), heuristics (mental shortcuts and extrapolation that can lead to errors), and loss aversion (the tendency to fear losses more than equivalent gains). Using these concepts, this study analyzes how investor psychology contributed to the inflation of each bubble and the severity of the subsequent crash. The paper is structured as follows: first, it discusses each of the three crises in turn, highlighting the behavioral factors at play; finally, it presents a conclusion summarizing the findings, acknowledging research limitations, and suggesting directions for future improvement.

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2. Case studies of historic crises

2.1. Dutch Tulip Mania

The Dutch Tulip Mania of the 1630s is often cited as the first recorded speculative bubble in financial history [9]. In the mid-1630s, tulip bulbs became a coveted asset in the Netherlands, with prices skyrocketing as both wealthy and ordinary people rushed into the trade. Rare tulip varieties sold for astonishing sums—by late 1636, some individual bulbs were reportedly worth more than a skilled artisan's yearly income. This frenzy was driven by the belief that one could resell bulbs at ever-higher prices, and for a time, tulips appeared to offer a shortcut to great wealth. The market grew euphoric and largely detached from the flowers' intrinsic value. The pivotal collapse came suddenly in early February 1637. At a routine bulb auction in Haarlem on February 5, 1637, the first lot of tulips drew no buyers at the lofty asking price. The auctioneer repeatedly lowered the price, but still no bids emerged. In that moment, confidence shattered—the spell was broken. As news spread that even a reduced price could not find a buyer, the once-plentiful liquidity from eager speculators evaporated almost instantaneously. Panic gripped the market: everyone now wanted to sell, but no one was willing to buy. Tulip prices, which had risen to outrageous heights, plummeted by over 95 percent in a matter of weeks. Contracts for bulbs that had been traded for hundreds of guilders became virtually worthless. In essence, the market for tulips 'simply ceased to exist', crashing as rapidly as it had ascended.

From a behavioral perspective, Tulip Mania exemplified the dynamics of crowd psychology in finance. During the boom, investors exhibited extreme herd behavior and overconfidence. People of all social classes joined the tulip craze because everyone around them was seemingly getting rich from it—a classic herd mentality. As one observer later recounted, speculators rushed to the tulip markets 'like flies around a honey-pot', each person convinced by the crowd's success that prices would keep rising. This collective optimism was a textbook case of what has been termed 'irrational exuberance': buyers wildly overestimated the true value of tulip bulbs, confident that they could resell to someone else at an even higher price [7]. Several cognitive biases likely fueled this mindset. Representativeness heuristic (a form of extrapolation bias) led many to assume that the recent rapid price increases were indicative of future gains. Investors also fell prey to fear of missing out and the bandwagon effect. When the turning point arrived, these same psychological forces reversed direction. Herd behavior flipped into a panicked stampede; once prices started dropping, loss aversion kicked in, creating a self-reinforcing downward spiral.

2.2. The great depression crash of 1929

The U.S. stock-market collapse of October 1929, which ushered in the Great Depression, was another dramatic case of a bubble fueled by optimism and then burst by panic. Throughout the 1920s, stock prices on the New York Stock Exchange soared to unprecedented heights. This period —the 'Roaring Twenties'—was marked by rapid economic growth and technological progress (mass production, automobiles, radios), which contributed to a general atmosphere of optimism. Many Americans began investing in stocks, and investing became almost a national pastime. Crucially, margin buying was widespread: investors could purchase stocks with as little as 10 percent cash down and 90 percent borrowed funds, meaning leverage of up to 10:1 was common. This easy credit amplified gains on the way up and would later amplify losses on the way down. By late 1929, stock valuations had far outrun real economic fundamentals, but the prevailing sentiment was that the boom would never end.

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The pivotal moment of collapse came at the end of October 1929. On Black Tuesday, October 29, panic selling reached its peak. Following a few days of mounting anxiety and heavy sell-offs (including Black Thursday on October 24 and Black Monday on October 28), Black Tuesday saw investors frantically dumping their shares. The Dow Jones Industrial Average plunged about 12 percent in that single day, capping a roughly 30 percent loss for the week. Billions of dollars of paper wealth were erased within hours. Crowds of stunned and desperate investors gathered outside brokerage houses and the New York Stock Exchange as iconic companies' stock prices collapsed. This stock-market crash marked the definitive end of the era's speculative euphoria, and it signaled the beginning of a severe economic downturn. By 1932, the Dow would bottom out almost 90 percent below its pre-crash peak, and the United States would be plunged into the Great Depression.

Behavioral factors were central to both the boom and bust of 1929. Herd behavior played a powerful role: as more people poured into stocks for quick gains, others followed suit, not wanting to miss out [10]. As the animal-spirits framework observes, the evaporation of public confidence and willingness to take risks helped prolong the Great Depression [8].

When cracks began to appear in the market in October 1929, sentiment turned on a dime from exuberance to fear. Panic contagion set in: seeing others sell triggered a reflex for investors to also sell before prices fell further. This is a clear manifestation of herd behavior in reverse—a rapid, collective rush for the exits. Loss aversion greatly amplified the urgency: faced with sudden declines, investors were driven by an intense desire to avoid further loss of wealth. Rather than holding stocks for the long term (which might have been rational if the companies were sound), people were psychologically compelled to cut their losses and get out, even at fire-sale prices. Bank runs during this period illustrate similar behavioral dynamics. As stock values collapsed, rumors spread that banks (many of which had also invested in the market or loaned against stocks) might fail. In response, crowds of depositors hurried to withdraw their money while they still could, a classic case of fear-driven herd behavior. These bank runs were essentially fueled by loss aversion—the panic was to avoid the possible loss of one's life savings if the bank collapsed.

The cumulative effect of these behaviors was devastating: the market crash was not just a rational revaluation of overpriced stocks, but a chaotic stampede exacerbated by psychology. Furthermore, the collapse in confidence after 1929 had long-lasting economic effects. Consumers and businesses, shaken by the crash, sharply cut back on spending and investment, deepening the economic contraction. As the animal-spirits framework observes, the evaporation of public confidence and willingness to take risks helped prolong the Great Depression [8]. In short, the 1929 crash and its aftermath vividly demonstrate how waves of overconfidence and collective panic, in line with behavioral-economics theories, can produce extreme volatility and contribute to a wider economic crisis.

2.3. Global financial crisis of 2008

The Global Financial Crisis of 2007–2008 was triggered by the collapse of a giant credit and housing bubble, and it provides a modern example of how behavioral factors can lead to financial catastrophe. In the early-to-mid 2000s, housing prices in the United States (and many other countries) rose dramatically year after year. This housing boom was fueled by readily available credit, low interest rates, and financial innovations that bundled mortgages into complex securities. Banks and mortgage lenders issued vast numbers of home loans, including risky subprime mortgages to borrowers with weak credit, under the assumption that rising home values would continue to cover any risks. These mortgages were pooled and sliced into mortgage-backed securities and collateralized debt obligations (CDOs) that were sold to investors worldwide. Major

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financial institutions accumulated huge exposures to these mortgage-related assets. By 2007, an intricate, highly leveraged pyramid of debt had built up, resting on the assumption that housing prices would never fall substantially.

The pivotal collapse event in this saga occurred in September 2008 with the failure of Lehman Brothers, a 158-year-old investment bank [11]. After a year of growing strains (starting with rising default rates in 2007 and the forced sale of Bear Stearns in March 2008), Lehman Brothers filed for bankruptcy on September 15, 2008. Lehman's sudden failure was a shock that sent immediate panic through global markets. It is widely seen as the trigger that turned a financial-sector downturn into a full-blown worldwide crisis. Almost overnight, credit markets froze as banks lost trust in each other's solvency, and stock markets plunged worldwide. Investors fled from anything perceived as risky, and the global financial system teetered on the brink of collapse. Only massive emergency interventions by governments and central banks—such as bailouts and liquidity injections—eventually stabilized the system. The fallout was severe: major economies fell into recession, millions lost jobs, and trillions of dollars of wealth evaporated [1, 10].

The 2008 crisis was rooted in a widespread breakdown of judgment across the financial system—a breakdown that can be traced to several behavioral tendencies. Overconfidence and optimism bias were rampant during the build-up of the housing bubble. Bank executives, traders, and regulators collectively underestimated the risks of subprime lending and complex derivatives. Many believed that their models and financial engineering had effectively dispersed or eliminated risk. This overconfidence led to moral hazard and excessive leverage: banks assumed housing prices would keep climbing and thus took on huge debt loads to invest in mortgage securities, convinced that they would not face large losses. Investors worldwide, from large hedge funds to small pension funds, were reassured by credit-rating agencies that these mortgage-backed instruments were safe (often rated AAA), and they perhaps naively trusted these ratings without scrutinizing the underlying quality of loans.

There was also a strong element of herd behavior: financial institutions and investors saw others earning high returns on subprime mortgage securities and jumped in as well. Almost everyone—lenders, investors, even homeowners speculating on real estate—was following the crowd, which created a self-perpetuating cycle of higher prices and greater risk-taking. Another key bias was the extrapolation heuristic: many market participants assumed that recent trends would continue. By the mid-2000s, it had become conventional wisdom that 'house prices never go down'. This belief was a clear example of representativeness bias, where people inferred future outcomes from a short run of past price increases. Studies of the crisis have highlighted that over-extrapolating past gains was a crucial psychological driver of the bubble. When housing prices finally stalled and began to decline, it caught these optimistic investors off guard.

Once the bubble began to burst, the psychology of the market flipped from reckless optimism to extreme fear. The period of late 2007 through 2008 witnessed a cascading loss of confidence. As mortgage-default rates surged and complex securities started to unravel, financial institutions suddenly faced enormous uncertainties about who might be holding toxic (nearly worthless) assets. Herd behavior now took the form of a generalized run on the banking and shadow-banking system: as rumors swirled and news of losses mounted, every institution and investor tried to withdraw from risky positions before others did. For example, short-term funding markets such as the commercial-paper and repo markets saw lenders a masse refuse to roll over loans to banks and investment firms, mirroring a collective run. This behavior was driven by loss aversion and panic—the instinct to avoid further losses led firms to hoard cash and sell assets in fire-sale fashion. When Lehman Brothers collapsed, it sent a signal of outright panic, and the reaction was a worldwide flight to

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safety. Banks that had happily lent to each other days before now refused to do so, fearing they too could lose everything. Investors dumped stocks and corporate bonds, even those unrelated to housing, causing asset prices to plummet across the board. This was essentially a giant, system-wide fire sale triggered by fear. The crisis thus unfolded very much in line with behavioral patterns: the same 'animal spirits' that had driven exuberant risk-taking in the boom turned into collective fear and distrust in the bust [8]. Importantly, the 2008 experience showed how dangerous the interaction of these biases can be in a tightly interconnected financial system. Overconfidence led to highly complex, leveraged positions; herd behavior meant that many institutions had similar exposures; and when fear set in, the resulting simultaneous rush to safety nearly brought down the entire global economy. In retrospect, the Global Financial Crisis underscores that financial markets are not ruled solely by rational calculus. Psychological factors—from overconfidence at the executive level to emotional decision-making by investors—were at the core of why the crisis escalated so quickly and severely.

3. Conclusion

This paper applied behavioral-economics theories to three major financial crises—the 1637 Tulip Mania, the 1929 stock-market crash, and the 2008 global crisis—and found striking commonalities in how human psychology contributed to each boom and bust. In all three episodes, periods of speculative excess were marked by investor overconfidence, euphoric risk-taking, and herd-driven buying frenzies that inflated asset prices beyond sustainable levels. People became convinced that 'this time is different', whether it was Dutch tulip speculators believing in ever-rising bulb prices, 1920s stock investors trusting in endless economic expansion, or mid-2000s market participants assuming perpetual housing-price gains. These beliefs were not purely rational expectations but were heavily influenced by narratives, social reinforcement, and cognitive biases. When reality eventually undermined these optimistic assumptions, the shifts in sentiment were dramatic. Each crisis featured a pivotal moment of collapse (a failed auction, a market-crash day, a major bankruptcy) that shattered confidence. What followed was a cascade of panic-selling, contagion, and credit contraction, driven largely by fear and loss aversion. Investors and institutions, gripped by the urge to avoid further losses, engaged in behaviors—from fire sales of assets to bank runs and credit freezes—that not only reflected panic but also intensified the downward spiral. Thus, a core conclusion is that financial crises cannot be fully understood without accounting for behavioral factors. Herd mentality, overconfidence, heuristics, and aversive reactions to losses acted as accelerants of both the inflating bubble and the destructive crash in these cases. This behavioral perspective complements traditional economic analyses by explaining why market actors collectively make extreme moves that defy fundamental values and why they often all rush for the exits at the same time. Recognizing these psychological elements gives a more comprehensive understanding of the causes and mechanics of financial crises.

While this analysis highlights important behavioral patterns, it also has limitations that suggest avenues for future research. First, it focused on a select three crises; although they are among the most famous, they may not capture all possible dynamics of other financial crises (for instance, the 1720 South Sea Bubble or the early-2000s dot-com crash might reveal additional insights or different biases at work). Further studies could extend the behavioral analysis to a broader sample of historical and modern crises to verify the universality of the observed patterns. Second, the approach is largely qualitative and retrospective. The role of biases was inferred from historical accounts and outcomes, but this method cannot easily quantify exactly how much each bias contributed, nor can it prove causation with certainty. Future research could benefit from quantitative analyses-for

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example, using sentiment indices, experimental asset markets, or big data on investor behavior—to measure the impact of psychological factors during bubbles and crashes more rigorously. Additionally, behavioral biases do not operate in isolation; they interact with institutional and regulatory factors. This discussion did not delve deeply into how regulatory structures, market mechanisms, or external shocks interplay with investor psychology. Incorporating those aspects would provide a more integrated picture. Finally, applying these insights to policy and prevention is a crucial next step. If herd behavior and overconfidence are known precursors to bubbles, regulators and central banks might develop early-warning indicators based on market sentiment or credit exuberance. Tools from behavioral economics—such as nudges or circuit breakers—could be explored to temper speculative enthusiasm or to calm panic in a downturn. Ongoing education for investors about common biases could also mitigate irrational decision-making. In conclusion, by acknowledging the powerful role of human psychology in financial markets, economists and policymakers can improve strategies to anticipate and counteract the extreme behaviors that give rise to financial crises. Continued interdisciplinary research at the intersection of economics, psychology, and finance will be key to building a more resilient financial system for the future.

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