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GREATER FOOL THEORY ON REAL ESTATE MARKET

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ABSTRACT

This paper basically discuss about the Greater fool theory on the Real estate market and its overall effects on the other markets and on the overall economy. So basically, **The Greater Fool Theory** is an investment belief, that says no matter how much overpriced the property or investment is, a investor would buy it thinking that there is always a greater fool than him who would buy from him and can make profits but in the actual sense this is imaginary and there could be chances of huge and irreplaceable losses.

This Greater Fool theory not only exist in Real estate market but also in stock market, gold etc. and this theory have a greater application on various markets.

This paper will elaborate upon the Greater fool theory on the Real estate market and explains how the bubbles are created in the real estate market and how it can further led to the crash of the Real Estate Market.

This paper also elaborates upon how the Demand in the real estate market would fluctuate due to the application of Greater Fool Theory.

RESEARCH METHODOLOGY

This report is based totally on important evaluation and analysis of essentially secondary facts.

Data means the information which has been accumulated without delay from the supply. Alternatively, secondary data means the statistics amassed from journals, newspapers and net, and so forth.

I have made the research on net , study diverse Journals and articles related to the subject which i have selected that isGreater Fool theory on Real Estate Market, which is the supply of my secondary statistics apart from this, a few newspapers, internet web sites helped me to acquire the secondary information.

OBJECTIVES

- How bubble is created in the Real Estate Market.
- How bubble created can affect in the Economy
- How it affects the other markets in the economy.

INTRODUCTION

The Greater Fool Theory, it's a phenomenon that occurs in all financial markets, not just in real estate. It starts when a few savvy speculators buy stocks, bonds, real estate, or other investments, and then sell them in a relatively short time frame and make a huge profit. Other not-so-savvy speculators then try to get in on the gravy train. This begins a flurry of buying and selling based on the theory that it doesn't matter how much you pay, a greater fool will come along and pay you more than what you paid.

As additional speculators enter the market, it precipitates a frenzy of buying that seems as if it will never end. Guess what? It does! Then when the market collapses and prices fall, the fools who bought last start crying for help. The savvy ones, those who started the whole mess, have probably taken their profits and moved on from speculating in real estate to speculating in oil. What makes the real estate collapse a crisis is that it has engulfed average working Americans who just wanted to buy a home. These people now stand to lose everything.

It depends on the type of the market. If there is a bubble in the market (real estate or stock), you can be benefited. You buy a stock or invest in a property. In a bubble, there can be irrational buying which can lead to rise in the prices and some buyers will be ready to pay a higher price than is the true value of the asset. On the other hand, if it the bubble bursts or investors as a collective realize that the market is overvalued, there will be no buyers. If you were looking for a buyer to pay a higher price, you will not find one. Some investors sell in such a market leading to further devaluation. Your property/stock can lose value quickly in this market. (It’s better to avoid bubbles than playing smart – it’s like “passing the parcel”, you never know what will happen when music stop)

Here we may use the another concept in this paper, it is called **Herd Mentality, also known as individuals doing the same thing as others in the group are doing so they can conform to the norm and their desires for acceptance and belonging to same group are met. They also feel they will be safe as, if they do the same thing as the group.** People subconsciously follow the group as they think they may not be able to think or take the right decision as they maybe less experienced .

ANALYSIS OF OBJECTIVES

- ## How bubble is created in the Real Estate Market

Unlike the stock market, where most people understand and accept the risk that stock prices might fall, most people who buy a house don't ever think that the value of their home might decrease.

Basically, in the Real estate market it is not more often that Price Bubble can occur because of the involvement of the high cost and high maintance cost of maintaining the house which can discourage the speculative behaviour. However, housing markets do go through periods of "irrational exuberance".

Mean Reversion

Too often, homeowners make wrong perception that the recent price performance will continue into the future without prior considering the long-term rates of price appreciation in the future and there may be the potential for mean reversion.The laws of finance say that markets may go through periods of rapid price appreciation or depreciation, in time, revert to a price point that puts them in line with where their long-term average rates of appreciation indicate they should be. This is known as mean reversion.

Prices in the real estatemarket follow this law of mean reversion too - after time of rapid price appreciation (or depreciation), they revert to where their long-term average rates of appreciation indicate they should be. Home price mean reversion can be rapid or gradual. Home prices might fall (or rise) quickly to a point that puts them back in line with the long-term average, or they might stay constant until the long-term average catches up with them.

The Causes of a Housing Market Bubble

The price of housing, like the price of any good or service in a free market, is driven by supply and demand. When demand increases and/or supply decreases, prices go up. In the absence of a natural disaster that might decrease the supply of housing, prices rise because demand trends outpace current supply trends. Just as important is that the supply of housing is slow to react to increases in demand because it takes a long time to build a house, and in highly developed areas there simply isn't any more land to build on. So, if there is a sudden or prolonged increase in demand, prices are sure to rise.

So when the Greater Fool Theory comes in play so due to every investor thinks that there would be another Greater fool which would buy from him even at the Greater price, so they keep on purchasing the properties and assets and which give the high demand in real estate market and eventually lead to high prices in the Real estate market which finally causes the Bubble in the economy

- ## How bubble created can affect in the Economy

First, asset prices often fall faster than they rise, so the downward correction can destroy value in a very short space of time. And second, most bubbles are fuelled by debt, because the only way a bubble can expand in the later stages is if the demand for the asset is bolstered by debt.

This combination – high debt and falling asset prices – generates a vicious cycle in which distressed debtors scramble to repair their balance sheets and sell their asset. This in turn pushes the price of that asset even lower, causing further distress to similar owners of the asset, and so on

The pain associated with a bursting bubble varies considerably. Sometimes economies rebound rather quickly from a burst bubble, as was the case after the breath-taking collapse of the dotcom bubble.

However, housing bubbles are in a league of their own. Historically, they have always led to severe recessions, and there is no reason to believe this should change. The next time is not different.
The answers on how to deal with a bubble range from "nothing" to "whatever it takes". The problem is that no-one (policy makers included) can reliably identify a bubble.

If there is such a thing as a bubble, we will only know for sure when the bubble is already popping. Acting early to prevent a bubble expanding further is risky and unpopular. It's a brave central banker who raises interest rates in anticipation of an increase in asset prices when the rest of the economy is humming along just fine, or even showing signs of weakness

Wealth effect

The wealth effect looks at the impact of rising value of assets on consumer spending.

A rise in the house prices creates an increase in wealth for householders. As a result of this increase in house prices, householders will generally:

1. Be more confident than before about spending and borrowing on credit cards. As, They can always sell their house in an emergency.
2. Increase in equity withdrawal. A rise in the house prices enables homeowners to take out a bigger mortgage. Banks can lend more on the basis of the increased price of the house. Households could use this bigger loan to spend on other items. This can create a significant increase in consumer spending. For example, in 2006, with rising house prices, equity withdrawal added an extra £14bn to consumer spending. In 2008, with falling house prices, equity withdrawal was -£7bn. (people taking opportunity to pay off mortgage)

Effect on economic growth

If house prices rise, then the wealth effect is likely to cause an increase in consumer spending. This will cause higher Aggregate Demand (AD), and it is likely to cause an increase in Real GDP and a higher rate of economic growth.

Similarly, a fall in house prices may cause decrease in consumer spending. This will led to decrease in Aggregate demand and it is likely to cause an decrease in Real GDP and a higher rate of economic.

Multiplier effect

If there is an increase in aggregate demand from rising house prices, there may also be a multiplier effect which causes the increase in aggregate demand to be bigger than the initial effect.

How does a fall in house prices affect the economy?

- When there is a fall in house prices, there tends to be a negative wealth effect and a negative impact on economic growth.
- Because households see a fall in house prices, their main form of wealth declines, this reduces their confidence to spend. They are more likely to devote a higher % of their income to try to pay off their mortgage early.
- Falling house prices cause more people to be trapped in negative equity (a situation where your house is worth less than outstanding mortgage). This causes a fall in spending and precludes any opportunity for equity withdrawal.
- Falling house prices have a negative impact on the construction of new houses.

How Bubble affects the other markets in the economy

It took some time, but they are finally beginning to get it. Leading financial analysts, money managers and economists have commenced to comprehend that real estate bubbles in many emerging markets could crash. The Nobel Laureate economist Paul Krugman wrote in his New York Times column that China was another emerging danger as its credit fueled real estate bubble burst. The same concept has at last dawned on hedge funds A hedge fund owned by the famous private equity firm Carlyle sent an elite strike team to do a “deep-dive research trip” to

China. It won't help. They might find what is, but they have no idea of what is to be.

. To solve the problem the US created one of the first "bad banks", the Resolution Trust Company (RTC). The banks transferred the bad loans to the RTC along with the job of foreclosing on and selling the property.

The RTC tried to do its job, but was stopped when local real estate interests complained loudly that sales of foreclosed property were depressing the market. When the RTC stopped selling, the market froze. The buyers stopped buying, because they knew the RTC would eventually have to clear its inventory. After a time economics overcame politics and the sales restarted.

Today the US has a similar problem. Almost 30% of houses sold in the US in 2011 were the result of foreclosures. Over 3 million homes have been foreclosed since the real estate market collapsed. But the market still has not cleared. Although many of the foreclosed homes do get sold, they make up less than one third of the houses that the banks actually repossess. The banks are slowly leaking these properties on to the market, because they are terrified that too much distressed inventory would depress prices further. The result is that the recovery has been slow. But at least the process is going forward, which is a lot better than nothing at all.

CONCLUSION

So hereby I conclude that Greater fool theory have a serious impact on the people's minds and their behaviour, as they want to purchase more and more Assets and properties as they think that they can convert them into cash anytime as there would be someone to buy from them even at the higher price. It have serious impacts over the economy like

How does a fall in house prices affect the economy?

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Because households see a fall in house prices, their main form of wealth declines, this reduces their confidence to spend. They are more likely to devote a higher % of their income to try to pay off their mortgage early and MPC of the economy may fall.

Falling house prices cause more people to be trapped in negative equity (a situation where your house is worth less than outstanding mortgage). This causes a fall in spending and precludes any opportunity for equity withdrawal.

Falling house prices have a negative impact on the construction of new houses.

It can even lead to bubble in the real estate market due to which a lot of money of customers is locked and in economy's circular flow it acts as the leakages and may hamper the economy's overall growth.

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