



## News Release

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### Is The Housing Bubble About to Burst?

*An opinion piece by Sander A. Diamond, professor of history, Keuka College*

KEUKA PARK, N.Y.—After five years of speculation in the housing market, prices of homes have reached unparalleled and unsustainable levels, not only in the United States but also in the nearly all of the advanced economies of the West. Homes that sold for \$100,000 four years ago are now being offered at five times that amount.

During any speculative mania, knowing when to sell is the key. As history tells us, some make fortunes, while others are left with pressing debt or are ruined.

The first speculative mania occurred in Holland where modern capitalism came into its own in the 17<sup>th</sup> century. Amsterdam was the home of the first stock exchange with the buying and selling of shares in new capitalist adventures. Dutch ships carried coffee from Java, salves from Africa, wood from the Baltic, and furs from North America. Speculation became the order of the day. Great fortunes were made. But the Dutch quickly learned that what goes up must come down.

From 1634-1637, money poured into one of the oddest niches of the new capitalist order: flowers, tulip bulbs to be precise. In the yellow petals of one variety, many saw gold. It turned out to be fool's gold. By 1637, the price of a bulb no longer had any relationship to its intrinsic value. The bubble burst, many were ruined, and the economy was momentarily destabilized.

Eighty years later, England experienced a major bubble with the over-inflated value of shares of the South Sea Trading Co., which had proposed to take over three-fifths of the government's debt. However, in 1720, the bubble deflated quickly, proving the rough and tumble nature of capitalism and its cycles of boom and bust.

Unquestionably, the greatest bust came in the fall of 1929. By October, the prices of countless shares of stock no longer had any relationship to corporate earnings. Margin buying was the order of the Roaring '20s. Investors would put down as little as possible, assuring their brokers that they would be paid back when the stocks were sold at 10 times the initial investment. Driven by speculative mania, old-fashioned greed, and a gold rush mentality, it was optimism—not common sense—that drove the market to unsustainable levels. More than half of the GDP poured into the market and it crashed. What followed was the Great Depression, the largest economic downturn in history.



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Today, there is fear that the speculative boom in the housing sector is about to either flatten or burst. Millions have bought homes and condos with “interest only” loans and other non-traditional instruments, assuming they can cover the inflated loans when they sell at a much higher price than when they bought. In Florida, 23 percent of all new housing was bought on speculation and nationwide, 13 percent of all new sales are for second homes. This is merely another version of the margin buying that characterized the 1920s.

Driven by historically low interest rates and the transfers of cash out of the stock market into the speculative boom, we have witnessed a new gold rush. However, even if rates remain low, many believe the market can’t sustain such inflated prices. When people start to feel that housing no longer has any relationship to its intrinsic value, a hole begins in the side of the bubble and values start to deflate. Buying on speculation always leads to panic selling, with millions trying to salvage most of their initial investment.

A bubble can either deflate gradually or collapse. There is no way to predict what will happen this time but with so many residential properties bought on speculation, many believe the latter will happen. It could trigger a major recession, since 90 percent of the GDP over the past four years has been in consumer spending and residential construction, nearly all on credit. And other parts of the economy are also weak. Most airlines are on federal life support. The bond ratings of GM and Ford have been reduced to the junk level. Our trade deficit and national debt are out of sight. The cost of health care is staggering and the Social Security system is in peril. With the price of oil at \$60 a barrel—50 percent greater than at this time a year ago—less and less money will pour into consumer spending.

All of the terrible “ifs” may not coalesce, causing a major recession, but just as tulip bulbs do not produce gold petals, a two-bedroom condo on a side street five miles from the ocean in some out-of-the-way part of Florida isn’t worth \$400,000.