

# Home Prices - How Did They Get So High?

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Saturday, 13 September 2008

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While visiting San Francisco and the surrounding areas recently (2008), my wife and I were amazed at the prices of houses. A two bedroom home which might sell for \$100,000 where we come from in Colorado was sometimes \$600,000 or more in San Francisco, Monterey, or Santa Cruz or San Jose. And these high prices were after the real estate bubble burst. At least that's what we thought. But apparently parts of the San Francisco Bay area were still seeing rising home prices.

{bot\_wrgoogle}Other areas of California have been hard hit of course. Some towns have seen prices drop in half in a matter of a couple years - not surprising to the rest of the country, where we all wondered how such prices could be sustained. Still, how did they get so high in the first place? Homes that average a half million dollars or more for a whole population? Some of those buyers must work at regular jobs, making only \$30,000 to \$40,000 annually. It didn't make sense. Or did it?

Several factors lead to high prices. Some of them are still in place, which could mean that prices might not fall much more. Or it could mean that if and when those factors change, further big declines are on the way.

## High Home Prices Come From Low Interest Rates

Take out an amortization book or find one of those payment calculators online, and see what the payment would be for your home if you had a 13.5% interest rate. People were paying this much in the early 80s. For example, a 30-year loan of \$200,000 would cost you \$2,292 for principle and interest each month.

Using that payment, see how much you can borrow at a 5.5% interest rate - as low as my old amortization book goes. Paying the same each month, you could borrow \$404,000. If you are following the math here, you can see that the sales price could be twice as high, and yet you would pay about the same each month. Obviously low interest rates allow people to pay a higher price. There is more to it than that, of course, since prices certainly more than doubled in most areas since the 1980s.

## Income Went Up

People are obviously able to pay more for housing as their income rises. Those who rent might be interested in owning a house when they start making more, driving demand, and therefore prices higher. Average income in this country was rising for a while. But that still doesn't quite explain the extremes. How, even with a decent income of \$60,000 per year, does one afford a \$600,000 house?

## Expectations Changed

The real estate bubble seemed to cause people to think home prices could rise faster than inflation forever - something a mathematician could refute in two minutes. They were convinced that homes were a great investment at any price. So while devoting no more than 30% of your income to a house made sense before, buyers started to spend up to half of their paycheck on a mortgage loan payment.

There was a frenzy to get in on the "game" while home prices were rising so fast. A couple might not actually be able to afford a house, but they could buy it with easy credit terms, drain their savings to make the payments for a couple years, and then sell for a profit before they ran out of money. Speculation like this became especially common in California and

Florida. The result? Some made money doing this. But with prices falling, there are record rates of foreclosure, and the game is over for now.

### High Home Prices - Other Factors

Easy credit allows more people to buy. That helped increase demand, and pushed prices higher. In the past, even those with a decent income had to save for a down payment, but no-money-down mortgage loans changed that. Interest-only loans - half the loans made in California at the height of the bubble - kept monthly payments down. The \$2,292 mentioned earlier pays for a \$500,000 loan if you need only pay interest.

There's another factor we discovered while in San Francisco. We were told more than once that people are sharing houses everywhere. A NASA engineer said that when he lived in San Jose, most of the homes in his suburban neighborhood had four families living in them. There might be six or more incomes helping to make the payments on the house.

The latter factor is a cultural phenomenon (most were Asian or Hispanic). Many people born here don't like the idea of living with other families, or living several to a room. Still, those who are willing to do so have found a way to afford a \$600,000 home. These buyers and the additional demand they create may contribute to the high home prices in some areas.

Finally a big part of the answer to how people can afford high home prices is that they can't really. We're seeing record after record being set for foreclosures across the country, and if we see interest rates rise in addition, we'll see those prices drop even more.

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