Inappropriately low interest rates are as dangerous as inappropriately high ones

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The global financial crisis had many causes, but among the more important of them was that the US Federal Reserve under Alan Greenspan, and his counterparts at central banks in other major advanced economies, kept interest rates too low for too long in the aftermath of the mild recessions which followed the collapse of the internet bubble at the beginning of the present decade.

The mistake was *not* in cutting official interest rates to what were, at the time, unprecedented lows after the 'tech wreck' and the terrorist attacks of 11 September 2001. Rather, the mistake was in keeping interest rates at the levels struck in response to those events until as late as November 2003 in Britain, August 2004 in the United States and December 2005 in the Euro zone, long after the requirement for unusually low interest rates (to counter the risks of recession and deflation) had passed.

Keeping interest rates too low for too long had two important consequences which came together in such devastating fashion in the global financial crisis.

First, the extended period of inappropriately low interest rates enticed many American households, whose incomes or previous credit histories would ordinarily have precluded them from becoming home owners, to take out mortgages which they were subsequently unable to service once interest rates eventually began returning to more normal levels. This consequence of abnormally low interest rates was, to be sure, compounded by the way in which sub-prime mortgages were constructed (with artificially low 'honeymoon' rates and capitalization of deferred interest payments), but sub-prime mortgages would never have caught on in the way that they did had the general level of interest rates not been so low for so long.

More generally, the extended period of unusually low interest rates also encouraged those who had previously been able to access mortgage finance to take on more debt than would have been possible otherwise, adding to the upward pressure on house prices from those newly enfranchised in the housing market.

Second, the extended period of unusually low interest rates encouraged investors to take on more risk in order to obtain rates of return that could no longer be provided by relatively low-risk investments. This 'ferocious search for yield', as Adair Turner, Chair of the UK Financial Services Authority has described it, prompted a response from the 'supply side' of the financial services sector in the form of an ever-growing range of increasingly risky investment products cater to the growing demand for them – products whose risk characteristics neither their creators nor regulators fully comprehended.

In short, the choices made by central banks in the US and other major advanced economies to keep short-term interest rates too low for too long encouraged both an increased demand for risky investment products and a greater supply of them.

One of the reasons (although, again, not the only one) why Australia's experience of the financial crisis has been less severe than that of most other Western countries is that Australia's central bank was one of the very few that *didn't* make the mistake of leaving interest rates too low for too long in the early years of this decade.

In the face of considerable criticism from many quarters, the Reserve Bank under then Governor Ian Macfarlane began raising Australian interest rates in May 2002, and lifted them another three times over the following eighteen months. These moves were accompanied by a fair amount of what Ian Macfarlane's successor, Glenn Stevens, has since described as 'open mouth operations' – a series of quite forthright (for a central banker) public statements designed to highlight the risks associated with highly geared property investments.

These measures helped curtail the 'housing bubble' that had been building in most Australian markets for some time; the ratio of house prices to incomes began declining from that point onward until 2007, whereas it continued rising in most other 'Anglo' countries.

There's little doubt that without these measures, more Australians would have taken out mortgages that they would have eventually been unable to service; there would have been more mortgage defaults, and more forced sales, putting more downward pressure on house prices; and banks and other mortgage lenders would have incurred bigger losses, than turned out to be the case.

So a key lesson from the financial crisis should be that inappropriately low interest rates can be as damaging as inappropriately high ones.

And that's a lesson that needs to be borne in mind in the current debate as to when, and how, the stimulus which has been provided in order to cushion the impact of the financial crisis should be unwound.

In most other Western countries, where net public debt is set to approach or in many cases exceed 100% of GDP over the next five years, fiscal policy settings are clearly unsustainable. Those countries need to give priority, as soon as economic conditions allow, to 'fiscal consolidation' (that is, cutting government spending and raising taxes). As a result, monetary policy will need to play a greater on-going role in supporting economic activity: and the damage done during the financial crisis to banks' capacity to lend, and to private sector balance sheets, will probably reduce (though not eliminate entirely) the risk of new bubbles emerging in circumstances where unusually low interest rates persist for an extended period.

In Australia, however, the situation is the opposite. Our fiscal policy settings are in no sense unsustainable: most other Western governments would swap their debt-to-GDP ratios for ours in an instant, were that possible. However our monetary policy settings are almost certainly not sustainable for much longer, given how much circumstances have changed from those which were envisaged when those settings were being established late last year and early this.

That's not to say that the Reserve Bank will, or indeed should, be lifting its cash rate at next month's Board meeting, or even the one after that. But it would be ironic, and ultimately tragic, if Australia's monetary authorities were now to make the mistake which to their great credit, and Australians' great benefit, they avoided making in the years leading up to the global financial crisis.

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