

PRESS RELEASE

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RBA FACES TOUGH CHALLENGE

Australian Assured Income Management Limited Managing Director, Martin Venier, is a fan of the way the Reserve Bank's actions have contributed to a strong and robust Australian economy. But now, it's questionable whether it's obligation to keep inflation between a long term target range of between 2% and 3% will backfire. Venier said, "Today's 3.9% inflation (yr to Sep'06) is not driven by demand pressures. It's driven by cost pressures. Things like petrol prices and food".

The RBA uses monetary policy to manage inflation. An increase in the target cash rate will lead to an increase in home loan rates and reduce the amount of spare income in the hands of the average family. Overall demand for goods and services ought to reduce, causing economic growth to slow. The theory being, lower economic growth will lead to lower inflation. The cash rate has increased by 2% since the 8th of May. Since then, we have had 8 interest rate increases of 0.25% culminating in the latest on the 8th of November 2006.

Highly geared households in New South Wales and Victoria are expected to feel most of the pinch. Venier believes the pressure on economic growth will be amplified because monetary policy is normally tightened when Australia's two largest economies, New South Wales and Victoria, are strong. They are now relatively weak.

So why does it matter? Well, firstly, a higher interest rate levels are unlikely to reduce cost driven inflation because in this instance, it is caused by global commodity markets and drought/climatic factors largely outside the control of Reserve Bank and the Australian government. Could persistent high petrol prices and fruit and vegetable prices lead a wage push? The Federal Government's new industrial relations policies will act to mitigate wage driven pressure. But persisting cost push inflation could force the RBA to a further increase in rates and we might then experience a mini version of what now is an arcane term, stagflation. Still, the RBA's actions will be a good foil for any demand driven pressures that might arise from the Federal Government's tax reductions.

On balance though, anecdotal evidence suggest petrol prices might have stabilized. Pressure on the highly geared economies of NSW and Victoria might soon lead to a halt in further rate increases. Look for buy opportunities in bonds of longer duration and in 6 month bills. Venier suggests talking to your independent financial adviser. The Australian Securities and Investments Commission has useful tips on selecting an adviser at www.asic.gov.au and the Financial Planning Association website at www.fpa.asn.au.

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