Weekly economics podcast: A done deal?

By Perpetual Corporate Trust
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By Stephen Roberts

According to the market and analysts it is a done deal that the RBA will cut the cash rate by 25bps to 3.60% at the two-day interest rate setting meeting this week. A rate cut seemed a near done deal at the July meeting and did not happen. Will the RBA surprise again this month and leave the cash rate on hold? We think not. We expect a rate cut, largely because the Q2 CPI report showed inflation has been inside the RBA's target band through the first half of

2025 and the labour market has been less tight in May and June. But we also expect that further rate cuts, if any, beyond August will be slow coming, mainly because the second half of 2025 is shaping up differently from the first-half, notably for growth in aggregate demand and inflation.

The main reason prompting the RBA to cut the cash rate this week is that the latest Q2 CPI report showed both headline and underlying travelling lower inside the RBA's 2-3% target band. Headline annual CPI inflation was 2.4% y-o-y in Q1 and came down to 2.1% in Q2, while underlying or trimmed mean inflation came down from 2.9% y-o-y in Q1 to 2.7% y-o-y in Q2. A second reason to cut the cash rate is that the labour market looked less tight in May and June with almost no growth in employment over the two months and with the unemployment rate lifting in June to 4.3% from 4.1% in every month from January through to May.

Inflation and the labour market are both lagging indicators of the strength of aggregate demand in the economy which was weak in quarterly GDP reports through 2024, although a little less weak in Q1 2025. The rough rule of thumb is that if aggregate demand growth is weak and showing signs of softness in lagging economic indicators such as inflation and the labour market, there is strong reason for monetary policy to move to a neutral, if not expansionary setting. That means the cash rate should be moved promptly back down towards the expected inflation rate.

The problem the RBA faces this week is that one of the important factors pointing to the need to cut the cash rate, the inflation rate, will not stay as low as it has been through the first half of 2025. It was not even as low as reported in the Q2 CPI for the majority of Australian households.

Taking first the issue of the not-so-low inflation rate for many Australian households, the cost-of living indices for various groups in Australia produced by the Australian Bureau of Statistics showed that annual inflation in Q2 for employees was 2.6% y-o-y; for age pensioners was 2.7%; and for other government transfer recipients was 3.1%, all higher than the CPI at 2.1%. The only group enjoying a lower inflation rate than the CPI was self-funded retirees at 1.7% y-o-y. More than 90% of Australians experienced higher annual inflation in Q2 than was recorded by the CPI.

Looking ahead, annual CPI inflation will rise in the second half of 2025 and in the first half of 2026 on a base effect. In short, the quarter-on-quarter CPI increases in Q3 and Q4 2025 will be higher than the 0.2% CPI increases in Q3 and Q4 2024 when cost-of-living government subsidies came in sharply reducing the price of electricity in particular, and holding down the quarterly CPI increases. Likely CPI increases in Q3 and Q4 2025 of 0.7% q-o-q or higher would see annual CPI inflation lift above 3% y-o-y in Q4 2025.

If this jump in inflation is just a passing base effect and CPI inflation returns to around 2.5% later in 2026 and in 2027, the RBA could reduce the cash rate to around 3.0%. The problem is

that it may not be just a base effect temporarily increasing inflation. There is evidence that growth in aggregate demand is starting to lift and that could serve to keep inflation higher in 2026 and 2027 requiring monetary policy to stay on the tight side of neutral setting. If inflation looks like travelling around 3% y-o-y in 2026 and 2027 that means the cash rate has to be at least 3.50% and probably higher.

The evidence of stronger aggregate demand growth already showing comes from data relating to housing activity, undeniably strengthening through the first half of 2025, and most recently household spending. Household spending rose 0.5% m-o-m in June and was up 4.8% y-o-y. In real terms, household spending rose in Q2 by 0.7% q-o-q and by 2.4% y-o-y. The much stronger quarterly real growth in household spending is likely to show in a stronger Q2 GDP report in early September.

With these signs of a quite pronounced lift in growth in aggregate demand, the RBA will need to tread cautiously using lagging indicators relating to softness in the economy last year to justify cutting the cash rate. We see room for a 25bps cash rate cut to 3.60% this week, but it will be a lineball call in all likelihood and hedged with commentary about the uncertain economic outlook and need to move cautiously.

We doubt whether the RBA will change much its May economic forecasts in the quarterly Monetary Policy Statement also out this week. Those forecasts provided reason for the RBA to tread very cautiously cutting the cash rate over the past three months. Nothing much has changed. Our view remains that the RBA will cut the cash rash one or at most two more times to 3.60% this week, possibly 3.35% later this year. we then see a lengthy period on hold with the next move beyond more likely to be a rate hike than a cut.

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