RBA Update May 2025

The Reserve Bank of Australia (RBA) Monetary Policy Board reduced its interest rates by 25bps, taking the cash rate target to 3.85% and the interest rate on Exchange Settlement balances to 3.75%. The decision was in line with market expectations.

Post-meeting Statement

The post-meeting statement was reshuffled, to highlight more balanced inflation risks, since:

- both headline and underlying inflation rates have moderated to be in the target range of 2-3%; and
- while headline inflation is expected to pick up on base effects from larger energy bill relief measures, core inflation is expected to remain in the target range through the forecast period.

The RBA continued to stress that the economic outlook remains uncertain. On top of the obvious global risks, the RBA again highlighted the still-tight labour market conditions, sluggish productivity growth, the uncertain outlook for household consumption and lags in monetary policy transmission.

The RBA judges that maintaining low and stable inflation to be its priority. However, there was a landmark change to the forward guidance, with full employment in focus along with price stability.

Statement on Monetary Policy

The highlights of the updated economic projections included in the May Statement on Monetary Policy, which incorporate the market pricing of cash rate cuts, are as follows:

- the inflation forecasts were revised downwards, with trimmed mean inflation now expected to decline to 2.6% in June 2025 and remain there until the end of the forecast horizon in June 2027;
- the unemployment rate forecasts were revised slightly upwards, with a peak expected at 4.3% (0.1ppts above the February forecast); and
- the GDP growth projection path was downgraded, with growth expected to peak at 2.2% rather than 2.4% forecast three months ago.

The RBA also provided a set of alternative scenarios, including a 'trade war' scenario, which would see the level of GDP down more than 3% from its baseline forecast by mid-2027, the unemployment rate rise to almost 6% and inflation to decelerate to just 2%.

Apart from updated projections, the SoMP included boxes on the impacts of tariffs and the recent floods, as well as the results from liaison. While floods are expected to have reduced Q1 GDP growth by 0.1-0.2ppts, the impacts of tariffs on Australian trade are judged to be limited. However, according to liaison results, businesses perceive uncertainty to be the highest since 2010, with risks to activity and prices in both directions.

Press Conference

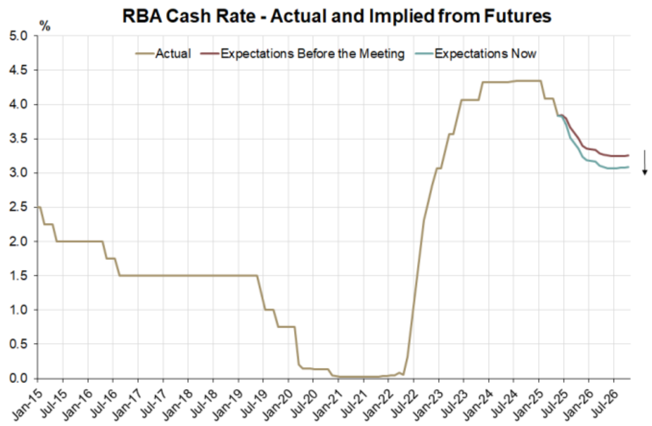
RBA Governor Michele Bullock's press conference contained the following additional information:

- the decision to cut rates by 25bps was unanimous and 'confident', but it followed a discussion on alternative options – including leaving rates unchanged or cutting them by 50bps;
- the RBA views current rate settings as mildly restrictive and preserving policy space; and
- the interest rate outlook remains highly uncertain and data-dependent, with Governor Bullock declining to endorse the market rate path, judging that it might price in a 'really bad outcome' from tariff policies.

Market Impact

The decision to cut rates was in line with expectations, but the forecasts downgrade and increased concerns over the outlook in the wake of US tariffs resulted in an intensification in market pricing for rate cuts. As a result:

- 3-year Commonwealth bond yields fell from 3.64% to 3.47%;
- 10-year yields declined from 4.49% to 4.40%; and
- the AUD depreciated from US$0.6445 to US$0.6423, with a local low of US$0.6410.



Comment

While an interest rate cut was expected, the RBA communication well and truly caught the market by surprise. However, it remains more cautious about the scale of further easing than what is being priced in by the market. This is fully justified given the degree of uncertainty and unpredictability in the environment of the Australian economy and ongoing home-grown inflation risks, mostly from the tight labour market and sluggish productivity. We anticipate cuts later this year, by 25bps each quarter, but recognise that the risks to this scenario are significant and both-sided.

20 May 2025