Decision of the Official Cash Rate May 2025

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Table of Contents

Report

Introduction

This report presents a simulated decision for the Official Cash Rate (OCR) to be held at 4.10% by the Reserve Bank of Australia's (RBA) Monetary Policy Committee (MPC) at the Monetary Policy Board Meeting in May 2025. This is deemed as the most appropriate monetary policy stance through an assessment of current economic conditions and consideration of the RBA's policy targets. The main objectives of the RBA are a dual mandate, comprising price stability and a level of full employment. To support sustainable economic growth and preserve the value of the Australian dollar, decisions by the MPC are made to maintain the inflation rate at its target range of 2-3%, achieving price stability. These decisions must also align with the aim of reaching full employment, by which the Australian labour force can find employment without driving up inflation.

The thorough analysis of multiple key economic factors has led to the decision of maintaining a cash rate of 4.10%. A slightly restrictive stance is vital as inflation has lowered, yet remains at the higher end of the target rate. Although unemployment rates are low, early signs of a softening labour market are evident in the Australian economy, drawing concerns of a decreasing demand for labour, and thus a potentially high level of unemployment in the future. Additionally, the continued impact of previous OCR increases are reflected in current slowed economic growth and reduced domestic demand. Risks of financial instability are contained, however signs of recovery from the housing market could interrupt inflation management, especially if the OCR were to be prematurely loosened. Finally, influence from global and external factors, including the unpredictable global markets, slowdown in China, one of our most significant trade partners, and magnified risks ensued by geopolitical conflict contribute to a wary approach to decisions regarding the OCR. Balancing global and domestic economic influences, a maintained cash rate of 4.10% is decided with significant consideration.

Inflation

Australia's recent inflation data supports the case for maintaining the OCR at 4.10%, as inflation is easing moderately and further tightening risks damaging economic momentum unnecessarily.

Figure 1: Australia's Inflation Rate

Headline inflation is projected to rise in 2025 due to the unwinding of temporary cost-of-living measures (e.g., electricity rebates), before returning to the 2–3% target in 2026. However, underlying inflation—excluding volatile items like food and energy—remains a better indicator of persistent inflationary trends. It is expected to stay slightly above the target range into late 2025, driven by sustained price pressures and a tightening labor market as GDP growth recovers. Key CPI components reveal sector-specific trends. Housing inflation is expected to moderate due to easing construction constraints and cooling demand. Retail goods inflation is also projected to ease gradually, as weak consumer demand limits the ability of retailers to pass on costs. Monitoring these individual sectors helps develop targeted policies rather than broad-based responses. Policymakers must avoid the risk of over-tightening monetary policy. Overestimating labor market tightness or inflationary pressures—especially if supply-side issues are easing—could unnecessarily hinder growth. Indicators like job vacancies and firm reports on labor availability should be assessed alongside the declining rate of job switching and wage growth patterns, which may reflect wage catch-up rather than market-driven increases. Monetary policy operates with lags, impacting asset prices, consumer demand, and employment over time. While easing interest rates is expected to support private demand and investment, past rate hikes still affect sectors like housing. Businesses are expected to respond positively to lower rates by increasing investment, but this depends also on broader economic conditions. Inflation expectations play a critical role. If they remain anchored, businesses and consumers are less likely to drive further inflation. However, rising expectations can become self-fulfilling, requiring central banks to manage them carefully to maintain economic stability and avoid aggressive policy shifts that may destabilize growth.

Labour Market & Wages

The stability of Australia's labour market, combined with its mature, service-oriented economy, supports maintaining the cash rate at 4.10% to preserve employment gains without reigniting inflationary pressures. The Australian labour market remains strong but shows early signs of easing, supporting the decision to hold the cash rate steady. The unemployment rate remained at a low 4.0% in March 2025, indicating that the economy is still operating near full employment. Although the participation rate slightly declined from 66.8% to 66.7%, this minor movement reflects a stabilising jobs market rather than a significant weakening. Overall employment growth continues, but at a slower pace compared to previous quarters, suggesting that labour demand is moderating in response to tighter monetary conditions.

Importantly, these labour market trends are not generating new inflationary pressures. Wage growth remains stable, with private sector wages increasing around 4.2% annually, and public sector wages growing at a slower pace. Early indicators suggest that the upcoming Wage Price Index (WPI) data will reinforce this steady trajectory. Wage growth is strong enough to support household consumption, but not so excessive as to drive a wage-price spiral. This balance indicates that monetary policy is currently restrictive enough to keep inflation expectations anchored.

According to the Phillips Curve theory, lower unemployment is typically associated with higher inflation due to rising wage demands. However, Australia's current experience shows a flattening of the Phillips Curve, where low unemployment is not translating into runaway wage inflation (see Figure 1). As shown, Australia's position has plateaued near the lower part of the curve - with a low unemployment rate around 4.0% and inflation easing - indicating that additional tightening would likely deliver diminishing returns. This moderation strengthens the case for maintaining the current cash rate, as further increases could unnecessarily weaken the labour market without meaningfully reducing inflation.

Australia's labour market composition also reinforces the case for a steady cash rate. A high percentage of employment is concentrated in the tertiary sector - services such as healthcare, education, and finance - which is typical of a developed economy. These industries generally exhibit more stable wage dynamics and lower volatility compared to manufacturing or resource extraction sectors. This structural strength helps Australia sustain low unemployment without triggering unsustainable wage growth.

In conclusion, stable unemployment, controlled wage growth, a strong service-based workforce, and Australia's position on the Phillips Curve together demonstrate that the labour market is not overheating. Maintaining the cash rate at 4.10% will support continued economic resilience without risking unnecessary job losses.

Figure 2: Inflation-Unemployment Trade-off in the RBA Phillips Curve Models

This figure illustrates the short-run relationship between unemployment and inflation, based on RBA model estimates. Australia's current position on the curve reflects a low unemployment rate with moderate inflation pressures, indicating a plateauing effect where further declines in unemployment would not significantly increase inflation. This supports maintaining a steady cash rate of 4.10%.

Economic Growth & Demand

Maintaining the Official Cash Rate (OCR) at its current level of 4.10% supports economic stability by preserving demand, protecting consumer confidence, and allowing for continued recovery in a fragile environment. Quarterly GDP growth sits at 0.6%, with 1.6% annual expansion, indicating a slow-moving recovery rather than strong momentum. While economic growth remains positive, its slowing pace suggests underlying weaknesses, particularly in business investment and household spending. Tightening monetary policy through higher interest rates (by increasing the OCR) would slow investment activity, as firms facing higher borrowing costs may delay expansion plans, hiring, and productivity improvements. Keeping the OCR steady prevents this risk, ensuring that financial conditions remain supportive rather than restrictive. Retail turnover remains soft, reinforcing concerns over weak demand. Households are exercising caution in discretionary spending, preferring to hold onto savings or reduce non-essential purchases. This aligns with low consumer sentiment, which currently stands at 90.1, significantly below the neutral threshold of 100. A pessimistic outlook among consumers suggests reduced willingness to engage in larger financial commitments, such as home purchases, renovations, or business startups. Given these fragile conditions, an increase in rates would exacerbate the slowdown, tightening borrowing conditions and discouraging spending even further. By maintaining the OCR, policymakers avoid deepening economic uncertainty and provide consumers with much-needed financial stability, fostering conditions that encourage gradual recovery. Higher interest rates at this stage would put unnecessary pressure on demand, making credit more expensive for households and businesses. Rising mortgage rates, loan repayments, and financing costs would significantly reduce disposable income, further discouraging spending. Additionally, businesses reliant on affordable credit for operations would experience reduced profitability and lower hiring rates, affecting employment levels and wages. Keeping the OCR unchanged ensures continued financial accessibility, allowing businesses to maintain steady operations while giving households confidence in managing their expenses. By opting to hold the OCR steady, monetary policy remains neutral yet supportive, striking a balance between controlling inflation and sustaining economic growth. Adjusting rates prematurely in an environment of soft demand and subdued GDP growth risks causing unnecessary disruptions. This cautious approach protects recovery efforts, ensuring that businesses and consumers alike have sufficient flexibility to navigate uncertain economic conditions without the added strain of tightening financial conditions.

Financial Stability & Housing

The resilience of Australia's financial system must be carefully weighed in maintaining the cash rate at 4.10%. Recent data shows housing prices are rising again; however, this is largely driven by tight supply rather than demand spurred by lower borrowing costs. Construction bottlenecks, zoning restrictions, and population growth are keeping supply constrained, meaning a rate hike would do little to address price pressures in this sector. Meanwhile, mortgage stress indicators are flashing caution signals, with a significant portion of variable-rate borrowers already devoting a large share of income to repayments. Household sensitivity to interest rate movements remains elevated, reflecting the rapid rate increases seen since 2022. Additionally, household savings rates have ticked up slightly, suggesting consumers are behaving cautiously, buffering against financial uncertainty rather than fuelling excess consumption. Given these conditions, keeping the OCR steady at 4.10% strikes a balance: it avoids worsening household stress, recognises the structural nature of housing price pressures, and supports financial stability without reigniting inflationary risks.

Global & External Factors

The chosen monetary policy stance is entailed by external economic and geopolitical risks which pose threat to the prosperity of Australia’s economy in the near future. For instance, Australia’s largest trading partner, China, is suddenly facing a slowdown in its economic growth.

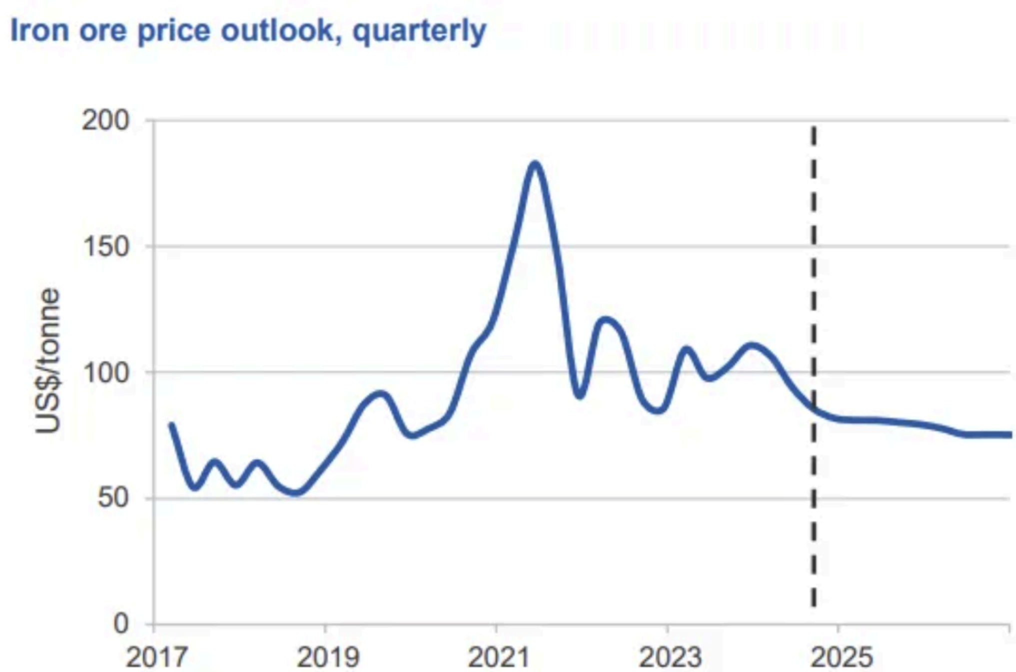

Figure 3: Predicted Outlook for Iron Ore Exports to China in 2025

As a result, price forecasts reveal a decline in Australian earnings from iron ore exports from $117 billion AUD in 2024–25 to $109 billion AUD in 2025–26, as shown in the gradually decreasing curve in Figure 2. This prediction is reflective of weakening Chinese demand for commodities in their real estate and construction sectors, presenting adverse circumstances for Australia’s economy. A drop in exports revenue may lead to increasing unemployment in one of Australia’s most successful and largest industries - mining.

Furthermore, in the United States, interest rates are being held steady at 4.25-4.50% as set by the Federal Reserve. After several interest rate increases to curb inflation, similar to Australia’s strategy following the rapid inflation in the post-lockdown period, the Federal Reserve has steadied their interest rates as their inflation rate has reached close to their national target of 2%. However, wary of potential economic downturn, the Federal Reserve has not further lowered their cash rate. If Australia were to alter their OCR, it would cause a division between the monetary policy stance between the RBA and the Federal Reserve, which could lead to exchange rate volatility. An appreciation of the Australian dollar would reduce export competitiveness, while a depreciation could increase imported inflation. Moreover, escalating geopolitical tensions such as the potential trade war between China and the U.S, and wars in Europe and the Middle East have disrupted trade routes and left global marketers in a state of unpredictability. Particularly, disruptions to supply chains and trade flows may restrict global economic growth, while increased risk could induce the deterrence of investment, posing the threat of a potential recession. Such global instability poses significant downside risks to Australia's open, trade-exposed economy. These potential circumstances have led towards the settlement of a cautious decision for the OCR.

Justification

The decision to maintain the Official Cash Rate (OCR) at 4.10% represents a carefully balanced approach by the Reserve Bank of Australia's (RBA) Monetary Policy Committee (MPC), synthesising a range of domestic and global indicators. This stance reflects the need to control inflation expectations while avoiding a collapse in demand, supporting the RBA's dual mandate of price stability and full employment. A hold at this level preserves current gains in economic stability, allows for continued adjustment from earlier rate increases, and provides space for future policy flexibility.Inflation, while easing, remains slightly above the target band of 2–3%, particularly in underlying measures. However, the risk of over-tightening is significant. Headline inflation is forecast to temporarily rise due to expiring cost-of-living subsidies but is expected to fall back within the target range in 2026. Given that inflation expectations remain broadly anchored, a steady cash rate helps consolidate recent disinflation without prematurely stifling recovery. Holding at 4.10% maintains a slightly restrictive stance, which is appropriate given current price pressures and the lagging effects of monetary policy. The labour market continues to show strength, with unemployment stable at 4.0%. However, subtle signs of weakening — including declining job vacancy rates and a slowdown in employment growth — suggest the market is beginning to adjust to past monetary tightening. Wage growth, while positive, is not excessive and appears consistent with inflation targets. Maintaining the OCR avoids unnecessary damage to employment while still exerting downward pressure on inflation through moderated demand.On the demand and growth front, GDP growth remains modest at 1.6% annually. Consumer confidence is low, and retail spending is subdued. Raising rates further would likely suppress investment and household consumption, amplifying downside risks to growth. Keeping the OCR unchanged sustains a cautious yet supportive environment that helps businesses and households navigate ongoing uncertainty. From a financial stability perspective, housing markets show price increases driven more by supply-side constraints than renewed demand. Rate-sensitive households are already experiencing repayment strain. A rate hold acknowledges these vulnerabilities without fuelling speculative housing activity, thereby safeguarding household balance sheets and broader financial resilience. Globally, heightened uncertainty from China's economic slowdown, the US Federal Reserve's policy pause, and broader geopolitical tensions call for a cautious monetary posture. A sudden change in interest rates could invite exchange rate volatility or recessionary spillovers. Thus, a hold at 4.10% best positions the RBA to manage both domestic inflation and employment while remaining adaptable to shifting global conditions.In conclusion, maintaining the cash rate reflects a prudent and well-rounded strategy — supporting a gradual return to target inflation while ensuring economic and financial stability amid uncertain domestic and global landscapes.

Conclusion

Maintaining the Official Cash Rate at 4.10% is the most appropriate course of action given current economic conditions. Inflation, while easing, remains above target and requires a cautious policy stance to ensure it continues to moderate. The labour market remains resilient but is showing early signs of softening, suggesting that further tightening could unnecessarily weaken employment outcomes. Economic growth is subdued, with both household spending and business investment sensitive to financial conditions, and a higher cash rate would risk amplifying these weaknesses. Conversely, a premature reduction in the OCR could undermine inflation control efforts and risk re-anchoring inflation expectations at higher levels. Financial stability considerations also support maintaining the current rate, as rising housing prices are primarily driven by supply constraints rather than renewed demand, and mortgage stress remains a significant concern. Holding the cash rate at 4.10% ensures that monetary policy remains appropriately restrictive while avoiding unnecessary strain on households, businesses, and employment. It provides flexibility to adjust policy if needed in response to future developments, supporting the RBA's dual objectives of price stability and full employment while fostering sustainable economic growth amid ongoing domestic and global uncertainties.

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