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Weekly economics podcast: The RBA's warning

By Perpetual Corporate Trust

15 December 2025

At the last interest rate setting meeting for 2025 the RBA has issued a warning that it may hike the cash rate in 2026. More precisely, the RBA Governor, Michelle Bullock said that the committee did not consider a rate cut, opted unanimously to hold the cash rate at 3.60%, and considered the circumstances that might require the RBA to hike the cash rate. Demand in the economy has picked up more strongly than the RBA forecast, inflation is running higher than expected – although some of the inflation pick-up may be temporary, and the labour market remains tight. The RBA is in data watching mode, but is now watching the data to see if there is a case to hike rates. Our view is that the RBA will get the demand and inflation data it needs to hike the cash rate before the next interest rate setting meeting in early-February 2026.

Our view is that the RBA will hike the cash rate by 25bps to 3.85% at the February meeting and will probably need to hike again after the February meeting, taking the cash rate up to 4.10% later in 2026. The factors driving the RBA to hike the cash rate are likely to be high monthly CPI readings for November and December with the headline inflation rate pushing up above 4.0% y-o-y and underlying inflation pushing up above 3.5% y-o-y.

Some of the lift in inflation is attributable to temporary factors such as the removal of government electricity rebates, but some is also attributable to demand running too hot, households lifting spending on consumer goods and housing, as well as the Federal and

State governments being able to reduce their spending anywhere near enough in the near term to reduce the steam building up in growth in aggregate demand.

Strong growth in aggregate demand would not be an inflation problem if Australia was enjoying strongly rising productivity, but of course that is not the case. Also, there are no signs of the Government trying to tie wage growth to productivity improvement. Instead, the Government is just pushing for higher wages – full stop – to help households cope with the rising cost-of-living.

With wage growth running above inflation for the time being and without strong linking of wage changes to productivity, the labour market does not need to be too tight to contribute to inflation pressure. The latest labour force report for November showed employment down by 21,300, but coming after a 41,100 increase in October. The unemployment rate stayed steady at 4.3% in November, a relatively low rate, and probably below the rate that is consistent with inflation not accelerating.

The RBA probably needs to see the unemployment rate at 4.4% or 4.5% to be confident that wage pressure is unlikely to add to inflation. It is not getting those higher unemployment rate numbers and we suspect it will not get those higher unemployment numbers in the December and January labour force reports, both out before the next RBA interest rate setting meeting in early-February.

What the RBA is likely to get between now and early February is more evidence of strong growth in spending by the household sector. The monthly household consumption expenditure report showed annual growth in spending rising strongly over recent months, from a high 5.1% y-o-y in September to an even stronger reading of 5.6% y-o-y in October. Anecdotal reports point to the acceleration continuing in November. Similarly, spending growth on housing remains strong.

The RBA is now in the position that it may have delivered too much stimulus to the economy with the three rate cuts in 2025. Indeed, given the lags between a rate cut occurring and the stimulatory impact on demand, the last two rate cuts are still working their way through to add more fuel to the demand (and inflation) fire.

The RBA has issued a warning that it is looking at the circumstances that could lead it to hike the cash rate. We believe that it will have ample evidence of strong demand growth and continuing high inflation by the time the interest rate setting committee meets again in February. We see the February RBA meeting very much a live meeting for a 25bps cash rate hike to 3.85%.

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