

Bank of Japan rate hike odds rise with strong inflationary pressures

Japanese data paint a mixed picture of the economy. There are growing downside risks as output contracts. Yet, there are increasing upside risks for inflation. The Bank of Japan is likely to prioritise price pressures. A 25 bp rate hike is expected in July



3.4%

Tokyo CPI inflation (%YoY)

Core excluding fresh food 3.6%

As expected

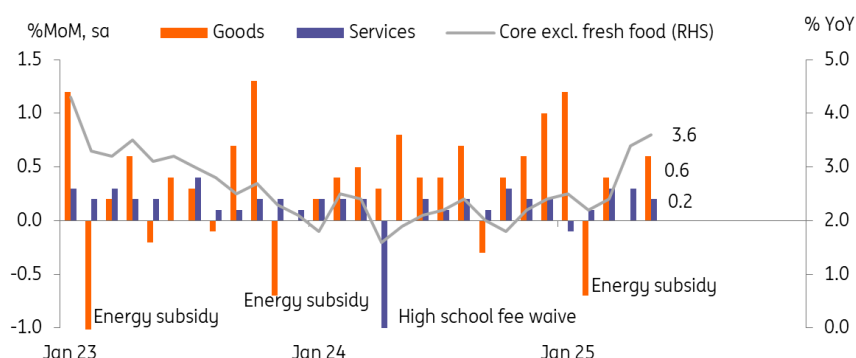
Core inflation accelerated more than expected in May

Tokyo consumer price index (CPI) inflation stayed at 3.4% year-on-year in May, in line with market consensus. Yet core inflation, excluding fresh food, accelerated to 3.6% from 3.4%, beating the market consensus of 3.5%. Core inflation has accelerated quite sharply for four months in a row, from 2.2% in February to 3.6% in May.

Fresh food prices eased sharply to 0.3% in May (vs 23.1% in January), thanks to stabilization of rice prices. But we saw earlier that hikes in fresh food prices continue to be passed on to processed food and eating-out prices. Utilities prices also edged down to 7.1% as a government subsidy programme ends and oil prices fell.

Excluding fresh food and energy, core-core inflation rose to 3.3% in May from 3.1% in April. We find that inflationary pressures are now across the board, with prices rising in housing, entertainment, and transport and communications. The government is planning to reinstate the utility subsidies in the summer months (July to September). This will lower electricity prices from August.

Service prices continued to rise in May



Source: CEIC

-0.9%

Higher than expected

Industrial Production (%MoM, sa)

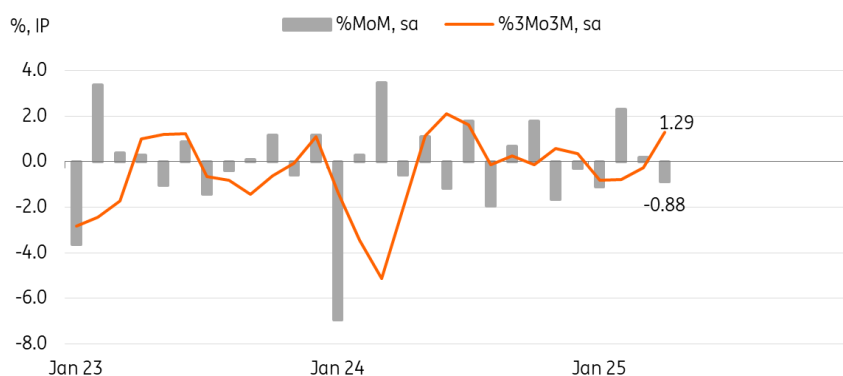
Retail sales 0.5%

Monthly activity data mixed with retail sales up, IP down

Industrial production fell -0.9% month on month, seasonally adjusted, in April (vs 0.2% in March, -1.4% market consensus). US tariffs began hitting output as auto makers appeared to cut production and tighten inventory control. Car production fell -0.3% in April, following an -8.4% drop in March. Petrochemicals and steels rose. Chip-making equipment dropped -7.5%. This partially offset strong gains in the previous two months (22.2% in Feb, 10.9% in March). Going forward, industrial production is likely to remain weak, dragging down overall growth in the current quarter.

Retail sales saw a modest 0.5% MoM rebound in April. A significant increase in auto sales (7.1%) was the main driver of this, while apparel and fuel sales also rose. Given strong wage growth and tight labour market conditions (unemployment rate at 2.5%), we believe household consumption is likely to improve in the current quarter. Nevertheless, it is unclear whether it will be strong enough to offset inflation.

Industrial production dropped modestly in April and weak auto output continued



Source: CEIC

BoJ watch

We believe that today's data still supports the BoJ's policy normalization process. Indeed, the BoJ is in a difficult position. Inflationary pressures remain hot, while the economic recovery remains fragile -- and facing strong headwinds from US tariffs. Also, the recent hike in long-term yields hurt market sentiment on growth and financial market stability. In our view, rising long-term yields are a sign that the economy is normalising as inflation is finally returning. Although recent spikes dampened market sentiment, the real interest rate has remained negative. The return of quantitative tightening (QT) is likely to undermine the BoJ's policy credibility. This will make the BoJ more cautious and slow the pace of rate hikes. Thus, we expect the BoJ to hike by 25 basis points in July, then pause until early next year. We think a 25 basis point hike is possible in the first half of next year. This will depend on US tariff policies and whether sustainable wage growth continues next year.

Author

Min Joo Kang

Senior Economist, South Korea and Japan

min.joo.kang@ing.com

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