

Japan's inflation higher-than-expected, but BoJ still likely on hold

Core Japanese inflation rose more than expected in May. Even so, the Bank of Japan is likely to prioritize the negative impact of US tariffs. If a trade deal is made by the third quarter, the BoJ may resume rate hikes



3.5% YoY

Consumer price inflation

Core inflation excluding fresh food : 3.7% YoY

As expected

Headline inflation moderated but core inflation accelerated more than expected in May

Japan's headline inflation moderated a bit to 3.5% year-on-year in May (vs 3.6% in April, 3.5% market consensus), in line with market expectations.

Yet, core inflation accelerated, suggesting underlying price pressures are building. Core prices, excluding fresh food, rose 3.7% in May (vs 3.5% in April 3.6% market consensus), while core inflation excluding both fresh food and energy accelerated to 3.3% in May (vs 3.0% in April, 3.2% market consensus).

As expected, the decline of fresh food prices (-0.1% YoY in May, vs 13.9% in March) was the main reason for the moderation of headline inflation. The government release of rice stockpiles is likely to be felt in the coming months. This should help pull down headline inflation ahead. However, inflationary pressures are across the board, with rent, transportation, and entertainment rising steadily.

In monthly comparisons, inflation accelerated 0.3% month on month, seasonally adjusted, in May (vs 0.1% in April) with both goods and services prices rising 0.5% and 0.2%, respectively. It's worth noting that core inflation growth of 0.5% was much faster than the headline.

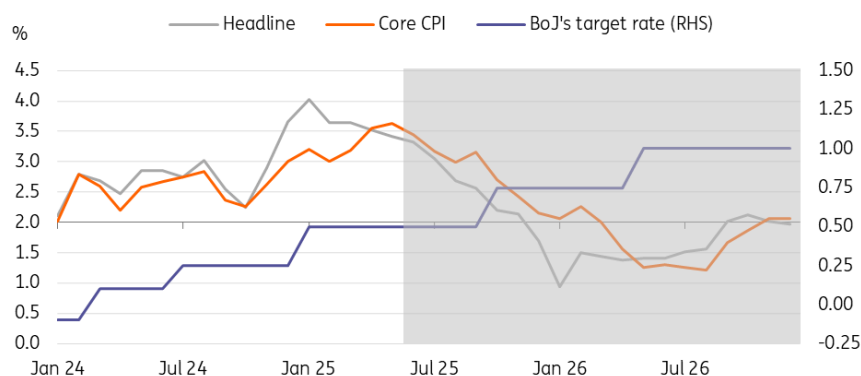
BoJ watch

At last week's Bank of Japan meeting, the central bank appeared to downplay rising prices, believing underlying inflation is still below its 2% target and inflation expectations are not yet anchored at 2%.

It is unclear how long the Bank of Japan will reserve judgment on inflation, despite the recent pick-up in core prices. For now, it's more concerned about the risk that US trade policies could break the virtuous circle of wage growth and inflation. This dynamic has been returning, albeit tepidly. Thus, we believe that the BoJ will be patient about inflation.

We believe that the BoJ could deliver a 25bp rate hike in the fourth quarter, assuming some form of trade deal with the US is finalised in Q3.

Japanese core inflation is expected to stay above 2% for a considerable time



Source: CEIC, ING estimates

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