

Interview with Shigeto Nagai, Head of Japan Economics, Oxford Economics

# Japan's Economy to Transition from Temporary Stagnation to Path of Moderate Growth in 2026

By Japan SPOTLIGHT

This cover story examines the growth prospects for the Japanese economy, driven by the expansion of the service sector. To provide context for this analysis, Shigeto Nagai, Head of Japan Economics at Oxford Economics and a macroeconomic expert, offers insights into the current state, outlook, and challenges facing the broader Japanese economy.

The Japanese economy is currently experiencing a slowdown. In addition to the US tariff shocks, food price inflation of more than 2% has reduced household disposable income, thereby weakening consumption. Consequently, however, the momentum of wage increases driven by labor shortages continues, and the trend of moderate growth fueled by wages is reportedly being maintained. This discussion also covers themes such as inflation risks, challenges in monetary and fiscal policy, the need for structural reform in the service sector, labor market issues, exchange rate trends, and population decline.

Japan's economy faces the risk of "mild stagflation" and companies must strive to boost productivity through digital investment and workforce redeployment. Concerns about fiscal sustainability, the need for redistribution discussions entailing increased burdens on affluent seniors, and the potential for digitalization to enhance productivity in the service sector despite IT talent shortages are also covered.

(Interviewed on Nov. 20, 2025)

## Assessment of the Current Economic Situation

**JS: What is your assessment of the current state of Japan's economy?**

**Nagai:** Currently, in addition to the shock of the Trump tariffs, inflation has remained stubbornly high above 2% due to rising food prices. This has eroded households' real disposable income, leading to sluggish consumption. The economy is currently in a phase of stagnation, but the momentum for wage increases, driven by labor shortages, remains solid. The underlying trend of wage-led, moderate growth itself remains intact. Looking ahead to next year, as the tariff shock fades, spring wage negotiations proceed at a level similar to this year, and food inflation subsides, consumption should gradually recover. We expect the economy to return to moderate growth around the potential growth rate (around 0.5%).

**JS: What are your thoughts on the risk of stagflation?**



Shigeto Nagai

**Nagai:** I believe the risk of falling into severe stagflation with remarkably high inflation as in the 1970s is small. However, there is a significant risk of falling into "mild stagflation" where cost-push inflation persists above 2%, household real income growth stagnates, and consumption fails to gain momentum. We are entering an era where structural wage pressures from labor shortages will persist, coupled with frequent inflationary shocks from global supply disruptions. To avoid being squeezed by rising costs, companies must pursue more efficient labor reallocation and profit margin improvements. Proactive management, including digital investments for labor savings, is essential.

## Expected Macroeconomic Policies

**JS: What is the desirable monetary policy?**

**Nagai:** Central bank monetary policy is now entering a more challenging era. There are two main reasons for this. First, we are in an era where inflation is significantly influenced not only by demand

but also by supply-side factors. Monetary policy has limitations in influencing inflation, as it can only affect demand through the route of raising or lowering interest rates. Second, the relationship between fiscal policy and monetary policy is changing. Recently, fiscal policy thinking is shifting toward more activism, such as stimulating short-term demand and promoting medium-to-long-term growth. Consequently, central banks now require more complex coordination and communication with governments to ensure appropriate alignment with fiscal policy.

### JS: What role is expected of fiscal policy?

**Nagai:** During the process of economic adaptation to situations like tariff shocks, a certain level of fiscal support is effective. For example, providing government guarantees and insurance functions for investments from Japan, as requested by the United States, is a reasonable choice, but there is also a risk of overdoing it. Support should be limited to supplementing projects undertaken by the private sector that are sufficiently profitable. A more serious problem in Japan is the vague anxiety spreading among the public about worsening living conditions amid a declining birthrate and aging population. Simply distributing additional tax revenue from inflation through supplementary budgets has its limits. Painful redistribution discussions are essential, such as increasing the burden on affluent seniors while reducing it for the working generation. Fiscal concerns will persist unless the funding issue is addressed, maintaining upward pressure on long-term interest rates. While a modest primary deficit under 10-year bond yields below 2% won't significantly increase the debt-to-GDP ratio, if long-term rates rise to around 3%, the risk of falling into a vicious cycle where the debt-to-GDP ratio keeps climbing becomes high.

## Structural Problem

### JS: Is the current wage increase sufficient?

**Nagai:** Whether wage increases are sufficient or insufficient depends on the metric used. From a macroeconomic perspective, current wage growth, which hasn't even kept pace with inflation, can be considered insufficient. However, micro-level corporate decision-making is a separate issue. Companies are implementing necessary wage hikes to secure skilled employees amid labor shortages, but they make these decisions within constraints: maximizing shareholder profits, balancing worker productivity and wages, and maintaining implicit long-term employment guarantees. To create

more room for companies to raise wages further, efforts to increase employee productivity are needed, requiring capital investment and management innovation. Workers also need to enhance their earning capacity through reskilling and similar measures. Particularly for large corporations, profits from overseas operations are increasing, raising the question of how much should be returned to personnel not contributing significantly domestically.

### JS: How do you assess the potential growth of the service industry?

**Nagai:** A major cause of Japan's low productivity lies in the low productivity of the service sector. Reasons include being forced into cost-cutting competition and a shrinking equilibrium amid stagnant domestic demand, the overwhelming share held by labor-intensive small and medium-sized enterprises (SMEs), and delays in IT and digitalization. However, precisely because productivity has been low, I believe the potential is significant. Particularly as wage pressures intensify due to labor shortages, the pressure to secure personnel by boosting productivity and profit margins will likely become a driving force for productivity improvement. However, the aging of SME owners and increased business closures mean a gap will emerge between companies capable of proactive investment and those that cannot. The key to digital investment lies in IT talent. However, the shortage of IT personnel is particularly severe among SMEs, creating the ironic situation where "IT investment needed to address labor shortages cannot be made due to labor shortages."

### JS: Is labor market mobility important?

**Nagai:** Labor market mobility is accelerating significantly. The movement of talented young professionals is particularly pronounced, creating challenges for companies to secure personnel. Young workers are already highly mobile due to market mechanisms. Additionally, the number of healthy veteran workers is increasing, with more seeking second or third career opportunities. This is a positive factor, especially in supporting labor shortages at SMEs. There is considerable potential for matching talent between urban and rural areas. The key to enhancing mobility lies in facilitating smooth transitions that emphasize not only salary but also job satisfaction.

## Other Issues

### JS: What is the outlook for exchange rates, which

## significantly impact the economy?

**Nagai:** Exchange rates fluctuate based on economic conditions and interest rate differentials between countries, but a long-term trend has emerged where the yen tends to weaken rather than strengthen. The primary driving force is the flow of money. While understanding exchange rates through the trade balance was once the mainstream approach, capital flows are now crucial. The majority of Japan's current account surplus is covered by profits from corporate foreign direct investment, and companies will likely continue investing abroad. Households, too, are increasing investments in overseas assets as savings rise amid a declining birthrate and aging population. This tendency for both corporations and individuals to expand external investment creates structural downward pressure on the yen. This pressure is likely to intensify further as the aging population and declining birthrate progress.

## JS: Will inflationary pressures from the weak yen persist for a long time?

**Nagai:** While excessively rapid yen depreciation can exert inflationary pressure, I believe that as long as appropriate monetary policy is maintained, the 2% inflation target will not be persistently exceeded by import inflation due to structural or trend-driven long-term pressures. However, it is unlikely we will return to an era of sustained disinflationary trends driven by yen appreciation, as seen in the past.

## JS: What are your thoughts on utilizing foreign workers as a countermeasure against population decline?

**Nagai:** While the pace of increasing foreign workers has become remarkably high, issues like inadequate working conditions and rising social friction have recently fueled a growing "anti-foreign worker" sentiment. The current visa system is positioned as "not an immigration policy" and its approach of permitting long-term stays while "using them as workers but not treating them as citizens" is problematic. However, anti-immigration and anti-globalization sentiments are not unique to Japan; they reflect underlying economic anxieties among citizens, making it unlikely that pro-immigration discussions will advance quickly. Addressing labor shortages is a problem politics must tackle; it cannot be solved by technology alone, such as AI. Labor shortages leading to supply shortages can cause inflation, and focusing solely on demand-boosting measures

risks keeping inflation persistently high.

## JS: Will advances in AI widen the income gap?

**Nagai:** There's no doubt people will be divided into those who use AI and those replaced by AI. However, there are also human-like services and abilities that AI cannot replicate, and opportunities may be found in those fields. While the US debates employment issues for young college graduates, Japan faces severe labor shortages. This creates significant room for absorption, making severe unemployment less likely. Nevertheless, the risk of polarization into "winners" and "losers" remains.

## Japan's Economic Outlook for 2026

### JS: What is the growth rate outlook for the Japanese economy in 2026?

**Nagai:** Reflecting what I just mentioned, we project GDP growth of approximately 1% in 2025, 0.6% in 2026, and around 0.4% in 2027.

### JS: Given the heightened uncertainty, how do you view the necessity of a vision?

**Nagai:** There is a problem with policy focus becoming increasingly short-term. Compared to think tanks like Brookings in the US, Japan lacks such institutions. Since the postwar period, bureaucrats have served as think tanks, but the deteriorating political status of bureaucrats in policy decision making and politicians' dominance over personnel decisions for bureaucrats have led to a decline in the quality of their work, leaving little room for considering long-term visions. The Bank of Japan barely maintains its function, and with the abolition of the Economic Planning Agency, there is a need for an institution capable of formulating major visions, such as addressing the declining birthrate and aging population. While scholars should be utilized in this effort, the actual implementation remains a difficult challenge.

JS

Translated from the original Japanese by Naoyuki Haraoka, editor-in-chief of *Japan SPOTLIGHT* & executive managing director of the Japan Economic Foundation (JEF).