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Our first take on the impact of immigration on eurozone inflation

Immigration can affect inflation and, in turn, monetary policy in two opposing ways. And the jury's still out as to its overall impact on the eurozone

Workers prepare the soccer fan zone by the Brandenburg Gate in Berlin

The Federal Reserve Chair Jerome Powell lauded the impact of immigration on inflation at an address at Stanford University last month. He argued that the expansion of the labour force due to a boost of migrant workers allowed the economy and employment to grow while the disinflationary process continued.

With that, he indicated that the soft landing was to an important degree influenced by immigration. Research on the impact of immigration on inflation and monetary policy is scarce and in its early stages. So we want to take an initial look at the possible impact that immigration could have on inflation and monetary policy in the eurozone.

? How does the correlation between inflation and migration work?

There are two main channels through which immigration potentially can affect inflation: a) through labour supply and wages; and b) through additional demand for goods and services.

Obviously, immigration increases the labour supply, which could put downward pressure on wages. This impact on wages depends on the skill composition of immigrants and whether they really match the required skills in sectors with high vacancy rates. At the same time, immigration increases demand for goods and services but also for housing. In the longer run, high-skilled immigrants tend to increase entrepreneurial activities, eventually enhancing productivity and economic growth.

In theory, these two main channels affect inflation in two opposing directions. While increased labour supply should be disinflationary, additional demand for goods, services and housing tends to push up inflationary pressures – at least initially.

Let’s take a look at the facts in the eurozone.

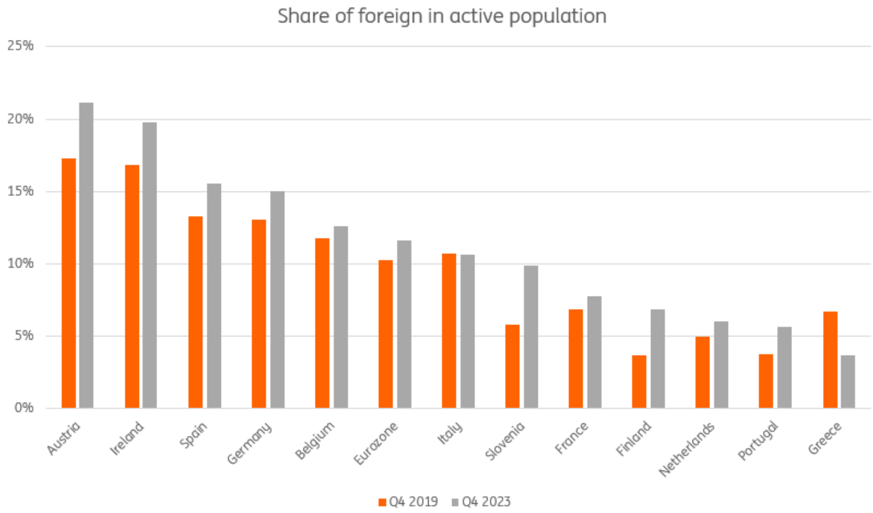
Impact of immigration on the labour market has been very important in the eurozone

In the eurozone, the active population (the combined employed and unemployed population) has expanded rapidly in the post-pandemic period – much faster than before the pandemic, even.

Between the fourth quarter of 2019 and the same period in 2023, the labour force grew by 2.8%. This expansion was to a significant degree driven by non-nationals [1]. In the eurozone, about 70% of the additional labour force can be attributed to the growth of the new non-national population. This could also mean that non-nationals are adding to the unemployment figure though, as the active population includes both those employed and those unemployed. Total employment in the eurozone has grown by 5.3 million since the fourth quarter of 2019, of which three million were non-national workers. So here, a majority of the growth in people at work comes from non-nationals.

[1] In this note, we use growth in non-nationals as a proxy for immigrants in the labour market. This does not hold 1-to-1 as non-nationals may have been in a country for a period of time before actively participating in the labour market.

The share of foreign active population is rising significantly in recent years across the eurozone



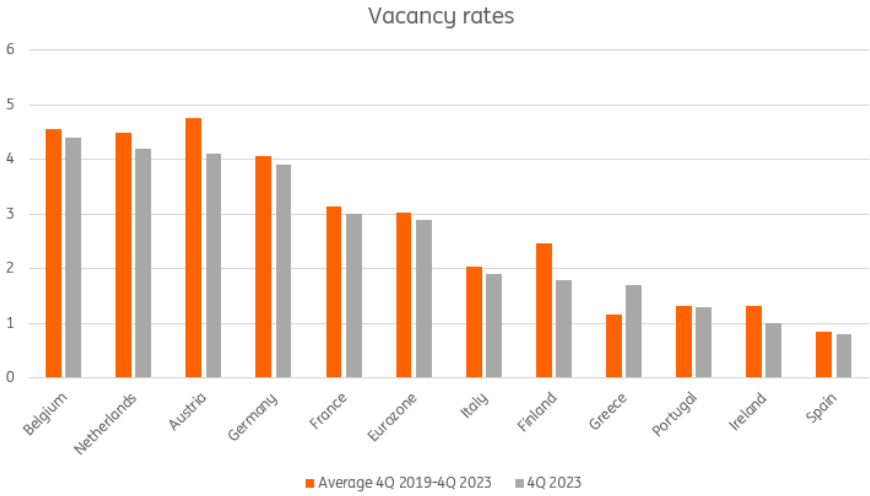
Source: Eurostat, ING Research

Still, for this to be relevant for inflation, labour shortages need to be a bottleneck in the economy. While eurozone inflation in 2021 and 2022 was mainly driven by supply shocks, services inflation is currently the main driver of an above-target headline inflation rate. Services companies often cite high wage growth as a main driver of higher selling prices. So labour shortages are an important factor in inflation in the eurozone at the moment, especially as businesses have indicated en masse that the lack of labour was limiting production, vacancy rates have hit historic highs and unemployment is currently at a historical low. Without immigration, these bottlenecks would be even more severe.

Beyond the eurozone level, there are large differences between countries and drivers in the expansion of the labour force. In Germany, the number of nationals in the active population shrank by more than half a million over the past four years, mainly as a result of retirement, while the number of non-nationals in the active population grew by more than 900,000. Without non-nationals, Germany would have seen the active population shrinking instead of growing. A similar trend can be seen in Austria and Portugal. In Spain, both nationals and non-nationals made a sizeable contribution to the growth of the active population, while in the Netherlands and Belgium, the impact was rather small compared to the growth of nationals. In Italy and Greece, the active non-national population shrank.

As a proxy of whether labour shortages are relevant, we look at vacancy rates and see that shortages are a much more pressing issue in the Netherlands, Belgium, Austria and Germany than in Italy and Spain for example. In the eurozone as a whole, non-nationals have contributed to the expansion of the labour supply, which – according to Jerome Powell's logic – will have contributed to easing price pressures, or at least wage pressure. This has far more been the case in Germany and Austria than in other large eurozone economies, as labour shortages have been high and the contribution of non-nationals to the expansion of the labour supply has been much larger than elsewhere.

Vacancy rates show that labour pressures differ a lot between countries



Source: Eurostat, ING Research

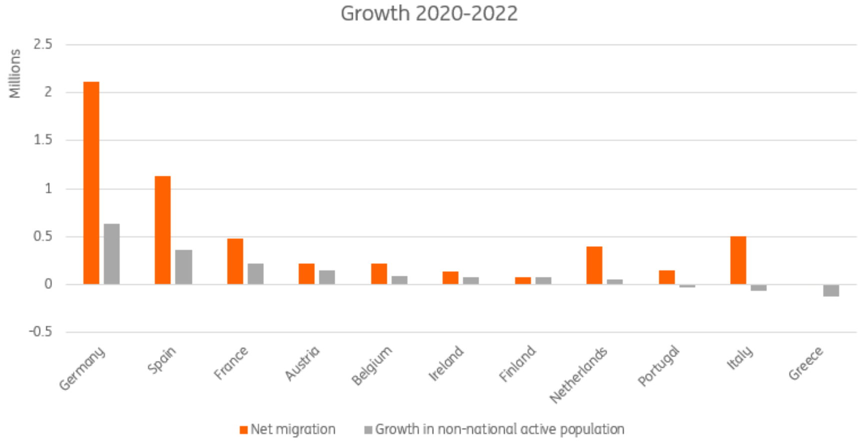
Impact of immigration on demand for goods, services and housing is less straightforward

To paraphrase former European Central Bank president Mario Draghi: more people can buy more goods. Very simply put, this is the impact immigration can also have on the economy, and consequently on inflation. Unsurprisingly, not all new immigrants have been integrated into the workforce, and so more demand than supply could have been created by immigration.

Indeed, the sum net migration for eurozone countries (this includes intra-eurozone migration) was just over 3.6 million in 2022, the latest year for which the data is available. That was up from 1.1 million in 2021 and probably reflects the Russian war in Ukraine to a large extent. From 2019 to 2022, net migration amounted to 5.8 million, while the new non-national active population came to 2.6 million. The chart below compares annual growth in net migration between 2019 and 2022 to non-national active population growth for the same period to allow for comparison. Here, we see that most countries have experienced a much larger inflow of migrants than of the non-national workforce. This is a potentially inflationary element.

But if there is already excess capacity in an economy, extra demand is unlikely to immediately be inflationary. Countries with a small negative output gap (or none at all) are less likely to experience an effect on inflation of immigration than countries that are overheating. At the moment, the output gap is quite small in the eurozone, but countries like Italy, Greece, Spain and Portugal are experiencing a positive output gap, indicating some overheating. Meanwhile, Germany has a negative output gap. Consequently, in Spain and Italy, the impact of higher net migration via demand for goods and services is likely to be more inflationary relative to Germany.

Net migration has been higher than the increase in non-national active population



Source: Eurostat, ING Research

The jury is still out on the overall macro effect of immigration

All in all, we don't think the impact of immigration on inflation is not as straightforward as Jerome Powell suggested. In fact, the question of how immigration affects inflation and monetary policy can only be answered by a typical economist's 'it depends'. It depends on the state of the labour market, the capacity levels of the economy and the skills of immigrants. In short, the absorbance capacity of the hosting economy.

Turning to the eurozone, it's undisputed that labour supply in the region has mainly been boosted by non-national workers this decade – but the degree to which this has alleviated or actually enhanced price pressures remains to be seen.

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