Miguel Fernández Ordóñez: Immigration and the inflation moderation debate

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Symposium "The Phillips curve and the natural rate hypothesis", Kiel Institute for the World Economy, Kiel, 3 June 2007.

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Introduction

It is a pleasure to be here today at this Symposium in such distinguished company.

The organisers have put together an impressive programme on a key topic for policymakers and central bankers in particular. As you know, the relationship between inflation and economic activity has always been at the heart of the macroeconomics discipline. And theoretical developments in this field have had a significant and direct influence on actual monetary policymaking.

We are currently in a unique situation. For an unusually long period, in the context of high global growth, inflation has remained low and stable.

Many commentators – and not only central bankers – would agree that better-managed monetary policy has had a lot to do with this favourable inflation performance. And there is a lively debate about which specific aspects of monetary policymaking have been responsible for it. Let's look at three questions this debate has raised. First, do central bankers now have better knowledge of the economy and of monetary policy transmission and, consequently, are adopting more effective decisions? Second, have monetary policy regimes shifted towards making price stability a more prominent target? And third, have structural changes in the world economy, such as the globalisation of capital, production and labour, made the job of central banks easier?

I will deal with all three questions today, but particularly with the effects of globalisation. I will focus mainly on labour market aspects, taking the immigration we have seen in Spain in recent years as an example of the positive effects that globalisation can have on inflation.

What is behind the recent success of central banks' in combating inflation?

Recent studies have given the credit for reducing the high inflation of the '70s and early '80s to the central banks' better knowledge of the economy. In my view, these studies have got it right. We have to admit that, at least in some countries, monetary policy didn't do all it could in the '70s to contain the oil shock-induced inflation of that time. Perhaps at that time, central banks lacked understanding of how supply shocks affect the output gap, as well as of the role of inflation expectations, and how these relate to monetary policy actions.

But I don't think that insufficient knowledge of the economy was the only factor explaining the rise in inflation during those years. Indeed, political will – or rather a lack of political will – could have been even more important. Germany is a good counter-example here, as a recent paper by Stephen Cechetti and others shows. After Bretton Woods, Germany realised that price stability was possible with a stable nominal anchor – a monetary target – that would prevent excessive accommodation of the supply shock. The Bundesbank's success made history. If others did not follow Germany's example, it was probably because they were not willing to put the same emphasis on reducing inflation. Simply, policy priorities were not the same in all countries.

I would therefore side with those who think that inflation moderation is largely thanks to a change in attitudes at central banks. A number of central banks, notably the US Fed, had already changed their reaction functions in the 80's, placing greater emphasis on minimising inflation deviations from an implicit target. And then, into the '90s, we saw a trend towards governments granting independence to central banks. Many central banks immediately adopted explicit inflation targets, thus making a clear commitment to price stability. If inflation is now lower and more stable than before, it is because central banks have decided to become less tolerant of it, and have been allowed to do so.

But these central bank changes were not a historical accident. Different countries' experience in a tackling inflation has helped prove the theory that there is no such thing as a long-term inflation-unemployment trade-off. We now accept that persistent inflation – even if it is low – involves a misallocation of resources with potentially heavy medium and long-term costs. At the same time, academics have shown how the short-term output costs of price stability can be kept down if central banks adopt credible and transparent targets. I will mention here the New-Keynesian theory of price determination, which convincingly relates current inflation to future expected inflation, providing a yardstick for monetary policy actions and communication. In the ECB Governing Council, we are proud that we have been able to continue anchoring inflation expectations at levels consistent with our definition of price stability.

But there is no room for complacency. The recent inflation success story and the central bank changes behind it need continuing social support. The public must have a clear-cut idea of what inflation means for their future income and job prospects. But while people appreciate the benefits of low inflation, differing national situations and economic conditions can alter preferences over time and from country to country.

Let's go back to monetary unification in Europe in the 90's. We could argue that European citizens were not exactly clamouring at that time for a fully independent central bank tasked with maintaining price stability for the euro zone as a whole. What is more, some critics viewed the fact that would-be EMU members had to meet nominal convergence criteria as a costly economic sacrifice that was justifiable only on political grounds, if at all. Yet in some countries, and certainly in Spain, countering inflation with tight monetary and fiscal policies led to a virtuous circle, once convergence became credible. Convergence went hand in hand with a sizable expansion in output which persists today. Thanks to this, Spanish citizens now undoubtedly appreciate the benefits deriving from macroeconomic stability.

But while the economic outlook is currently quite bright, this has not always been the case for the euro area economy as a whole in the period since EMU began. We are all aware that the blame lies not with an unduly tight monetary policy, but rather with adverse cyclical developments and, particularly, with structural rigidities that have cramped growth and employment in some euro countries. With growth subdued, it is more difficult for the public to see how a single monetary policy geared to price stability, contributes to their well-being.

Perhaps then, widespread support for the goals of independent central banks will not always be there unless central banks and other authorities insist on the right messages. The Eurosystem has recently launched very successful educational initiatives in this regard. But politicians should also be key players, making clear the role of monetary policy in increasing social welfare.

Globalisation

Going back to the debate on inflation moderation, I believe that international competition is helping to contain inflation as it guests favourable political economy effects. In particular, market globalisation is strengthening the public's aversion to inflation. Higher wages and prices immediately erode competitiveness punishing output and employment, and thus people see the damages of inflation more clearly than before. Also, as prices become more closely tied to global rather than domestic conditions, the perception of any trade-off between inflation and domestic unemployment weakens. Thus we can expect to see globalisation triggering public support for central banks' price stability goals, which in turn would become more credible, enhancing the monetary authorities' ability to deliver.

Structural considerations aside, there is an ongoing debate about whether globalisation is already pushing inflation down. I would say cheaper imports would normally affect inflation favourably, though the scale and persistence of this type of effect is uncertain.

But globalisation is not just about greater trade flows or about the effect of worldwide competition on goods and services markets. As far as wages and prices are concerned, the effects of internationalisation on the labour market are probably more important. If workers fear that their companies will move abroad, this can affect their wage demands, which can in turn temper the growth of production costs and consumer prices. Immigration acts in a similar way, easing demand pressure in the labour market and thus containing wage increases.

As I see it, labour market globalisation has already had a visible effect on wages in Europe and in other industrialised areas. Wage restraint has helped subdue inflationary pressure in the euro zone, despite recurrent supply shocks. The result has been an accommodative policy stance for much of the life of the monetary union, as at present. As you can imagine, on the ECB Governing Council we closely track labour negotiations in several countries, as the outcomes can directly affect the prospects for price stability.

Immigration

In several euro zone economies, and notably in Spain, it is immigration that has had the biggest economic impact. Immigration to Europe has surged and taken several forms. Sometimes you will see workers move permanently from one country to another. In other cases, they move back and forth. What is happened is that immigrants have not only increased the labour force in the euro area; they have also brought more flexibility and dynamism to our labour markets.

Since the turn of the century, Spain's immigration rate has been the highest in Europe. Once an emigration country, Spain's foreign resident population rose from just over 900,000 in the year 2000 to 4.2 million in 2006. As a result, Spain's population has increased by a number roughly equivalent to the total population of Ireland in just six years, as a result of immigration. The proportion of immigrants in other Western European countries may be bigger yet, but it is hard to find examples in recent times of such a large influx of immigration in such a small period of time. Clearly, what has attracted the immigrants to Spain rather than to other euro-zone countries has been the long economic upturn that has already lasted thirteen years.

To give you another idea of what immigration has meant for the Spanish economy, let me tell you that foreign residents accounted for nearly the entire growth of the working age population between 2001 and 2006. What is more, as immigrants have a higher propensity to work, they have also helped to increase the aggregate employment rate through a composition effect. If we simply combine these two direct effects, immigration accounts for almost one-third of Spain's notable GDP per capita growth since the turn of the century. This figure would be even larger if we took other indirect effects into account. For instance, immigrants' readiness to take jobs caring for children and the elderly has pushed up the participation rate and the productivity of native female workers.

Let me add, that despite Spain's inflation differential with the euro zone, which is now standing at around half a percentage point over the euro area average, immigration has helped ease the inflationary pressure that results from buoyant domestic demand.

How does immigration affect inflation? In two ways.

First, an increasing labour force raises growth potential, which helps reduce the feed-through of strong demand pressures to inflation. Usually, any boost to output is followed by a rise in real wages and, thus, marginal costs, which translate into higher inflation. But this feed-through need not take place if rising labour demand is met with rising labour supply from abroad, as we have seen in Spain in the last few years.

And second, as immigrants are much more mobile than natives – both across and within borders – labour supply becomes more responsive to changes in economic conditions. This helps reduce labour market tightness in the presence of positive demand shocks, and softens upward wage and price adjustments. Therefore, the higher mobility of immigrants across countries, sectors and occupations gives a better output-inflation trade-off. In other words, we can sustain bigger and longer-lasting expansions with more moderate effects on inflation.

But the cross-border mobility of immigrants is greatly affected by how strict the receiving country's immigration policies are. Immigrants will return home more willingly, or move temporarily to an alternative destination, when re-entry is easier. Governments should take this into account when designing immigration policies, and co-ordination among European countries in this area also needs to be stepped up.

I believe that cross-country labour mobility brings sizeable benefits for global economic prosperity. But high immigration also poses many challenges, not least the social assimilation of the new foreign residents. Here we need effective policies to hold the rate of immigration at the right level.

There is little doubt that immigration cannot carry on increasing indefinitely at high rates. And we must not forget that the favourable effects on inflation may gradually fall off as inward flows of foreign workers diminish.

As immigrants are more willing to substitute consumption for leisure, we might expect their participation rates and the number of hours they wish to work to be higher than those of the native population. At the same time, as most would already try to work to the maximum extent possible immediately after arriving, each of them will have limited availability to further increase their working hours. The labour supply of each immigrant will then become rather insensitive to changes in wages. The result of this is that after a positive shock for economic activity, wages will have to increase substantially in order to convince a given set of foreign workers to satisfy the additional labour demanded by employers. This means that once immigration stabilises at more moderate levels than those we have recently seen in Spain, it could be more difficult for labour supply to respond to higher demand, and we'd have higher wage and price pressures. But I think the slowdown in immigration in Spain is still some way off, so we can expect new arrivals to continue having a favourable influence on output and inflation for some time to come.

I am more worried about the risk that the beneficial effects of immigration could weaken the political will to reform the labour market. As we have seen, the arrival of workers with higher participation rates and lower reservation wages normally helps to increase employment and ease wage growth, at least for some types of workers. And that might leave us with a notion that the labour market is more flexible and efficient than it really is. There is a danger that policymakers become over-complacent. In fact, reforms will enhance the gains from immigration, as there is some evidence that immigration offers most benefits in those countries with more flexible labour markets.

Let me finish by recalling the words of Mr. Kofi Anan, the former United Nations Secretary-General, from a speech delivered to the European Parliament: "Migrants need Europe. But Europe also needs migrants. A closed Europe would be a meaner, poorer, weaker, older Europe. An open Europe will be a fairer, richer, stronger, younger Europe – provided you manage migration well". It is hard to disagree with him. Managing migration well, will be very good for social and economic stability and will help make our job of maintaining moderate inflation easier.