Box VI-1

The impact of foreign labour on inflation

There has been a sharp increase in the number of migrant workers in the Icelandic labour market in recent years. A larger working population increases the potential output of the economy and may affect wage and productivity developments and the level of unemployment that is compatible with a low rate of inflation. However, labour imports affect not only the supply side of the economy, but also the demand side, because migrant workers are also consumers of goods and services. The impact of foreign labour on supply and demand equilibrium is complex and the inflationary impact is not always straightforward.

Demand side impact

Imported labour affects demand in the economy through purchases of goods and services. Migrant workers buy food and consumer durables, and need housing. Their consumer behaviour is probably influenced by how long they intend to stay. A large proportion of the foreign labour force in recent years came to Iceland only for temporary work, especially on projects in the aluminium and power sectors. Their consumption over and above basic necessities is therefore probably lower than otherwise and they are likely to have made remittances of savings from their earnings. If this has been the case, the impact of foreign workers on demand will have been much slighter than if they intended to settle permanently in Iceland.

A larger permanent migrant labour pool increases demand for housing. Because of the lag between housing supply and demand, the unexpected boost to demand drives up housing prices. This in turn increases the mortgage capacity of house owners, thereby raising aggregate demand. However, much of the surge in house prices in Iceland in recent years is probably explained by other factors than increased demand from migrant labour, since a large proportion of them have been engaged in temporary work and lived in housing provided by their employers.

Supply side impact

An increase in the supply of foreign labour can have a substantial impact on wages and productivity, and thereby on inflation and monetary policy conduct. The scale of this impact is closely related to the characteristics of both the domestic and foreign labour force, and the interaction between them.

The wage impact may take three forms, with different inflationary impacts. If the imported labour force has a lower productivity rate than domestic workers, the reduction in total productivity may temporarily ease aggregate wage inflation, without affecting unit labour costs and inflationary pressures. Thus it would have no impact on monetary policy.

The impact on aggregate productivity would be zero if the imported labour replaces domestic labour with a similar productivity, but positive if it replaces less productive workers. Higher productivity would be reflected in lower unit labour costs, thereby easing inflationary pressures.

If the imported labour injects skills that are lacking, this boosts efficiency on the supply side of the economy while reducing wage inflation at the same time. Hence, increased supply of foreign labour should temper the growth in unit labour costs. A reduced mismatch between supply and demand can also lower the natural rate of unemployment, so unemployment can fall by more without forming inflationary pressures.

Inflationary impact

It is likely that the foreign input in the Icelandic labour market has had more effect on the supply side of the economy than on the demand side, thereby easing inflationary pressures. Given the age composition of the foreign labour pool and the relatively high proportion of males in it, they may be expected to have a higher participation rate than the average for Icelandic nationals. Since a large proportion of the migrant workers have only been temporarily employed, they are likely to have saved a larger share of their wages than domestic workers, with a correspondingly subdued impact on demand. Labour imports have therefore been a key factor in steering the economy through the turbulence of recent years and have helped to prevent inflation from running even higher than the current rate.