



Temporary immigration boom: A wake-up call for politicians?

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Germany has become the No. 1 destination country for migrants in Europe again and No. 2 in the whole OECD after the United States. In 2013, 437,300 migrants (net) arrived in Germany, the highest surplus in 20 years. In 2009 it was still a net emigration country.

The turnaround reflects the crisis in the EMU periphery as well as the (postponed) opening of the German labour market to citizens from the 10 Central and Eastern European countries that joined the EU in 2004 and 2007. Immigration from the peripheral countries has gone up, to a net 85,300 in 2013, but this is still not enough for an optimal currency area.

Not just the quantity, but also the quality of migrants has improved. In the past decade the share of graduates among them has nearly doubled to 43% (among German nationals 28%). This reinforces the positive impact on the economy.

Immigrants are highly welcome given the cyclical tightness, mismatch problems and, even more importantly, to mitigate the demographic headwinds blowing against the German labour market. Without intensified immigration the population would shrink by about 20% by 2060. In important industries, like IT and mechanical and automotive engineering, the shortage of skilled labour has already become a problem.

The increase in immigration should trigger a temporary 0.4 pp increase in potential GDP growth and lower wage growth. In 2014 and 2015 migration should add over 300,000 people to the domestic labour force each year for a total of about 45 m. This still assumes a somewhat lower productivity reading compared to the domestic labour force despite higher qualification level and flexibility, given the likelihood of teething troubles. However, when these migrants return to their home countries the same effect has to be subtracted from the potential growth rate. The additional labour supply eases wage pressure by shaving off at least 0.2 pp from wage growth.

The higher immigration should only temporarily obscure the negative effects from the introduction of a minimum wage and the retirement wave triggered by the "pension at 63" option. Therefore, Germany should push to leverage the inflow of foreign labour by enhancing the conditions for its efficient use, e.g. simpler and faster recognition of foreign formal qualifications.

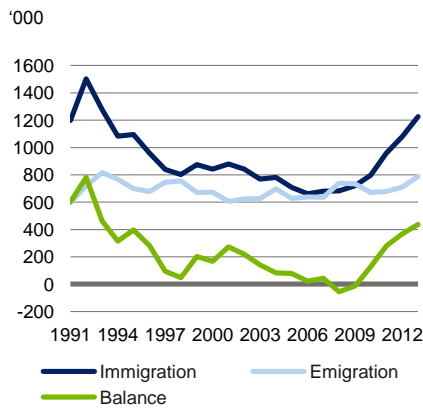
Given the economic recovery in the eurozone periphery the present migration surge is unlikely to last and ageing Germany's demand for labour from outside the EU will increase. The only temporary and largely push-based immigration boom should thus serve as a wake-up call. Germany needs to shape up to encourage more pull-based immigration. This requires a skills-oriented migration policy as well as more flexibility in the labour market and at the company level.



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Cross-border migration in Germany, 1991-2013

1



Source: Federal Statistical Office

Germany is No. 1 destination for migrants in Europe again

Following a relatively long downtrend especially in the past decade the number of immigrants to Germany has surged since 2010. The net migration balance showed a surplus of 437,300 persons in 2013. This means Germany has reclaimed top spot in Europe as a destination for migrants and is No. 2 in the OECD after the US. As recently as 2009 and 2008 the net migration balance was still negative at -12,800 and -55,700 respectively.

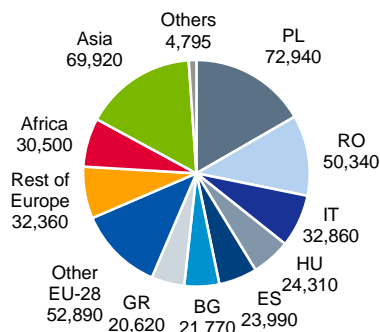
Migration given a strong boost by the euro crisis

The migration turnaround reflects the crisis in the EMU periphery as well as the postponed opening of the German labour market to citizens from countries in Central and Eastern Europe that joined the EU in 2004 and 2007. The crisis in the western European countries of Greece, Ireland, Italy, Portugal and Spain (a.k.a. the GIIPS), unleashed a wave of emigration there encompassing former immigrants from South America and south-eastern Europe as well an increasing number of indigenous nationals of late. In this context, Germany has increasingly gained in significance as a destination country above all for citizens of the GIIPS, albeit from a very low starting level. In 2013, a net surplus of 85,300 persons migrated to Germany from these five countries. Most of them came from Italy.

Net migration to Germany 2013

2

Total 437,300



Source: Federal Statistical Office

The change in the migration flows within the euro area is closely linked with the asymmetric consequences of the crisis for the national labour markets. While employment has increased in Germany over the past few years and unemployment has fallen to the lows of the last 20 years, joblessness has skyrocketed in the periphery. Most recently, especially Greece with seasonally adjusted joblessness of 26.8% (March) and Spain with 25.1% (May) continue to post an unemployment rate that is many times higher than the reading in Germany (5.1% in May).

Migration helping to mitigate the adjustment burden

In this situation emigration from the crisis-wracked peripheral countries provides a way to vent the pressures on the regional labour markets. In Germany, immigration is helping to ease the bottlenecks in a labour market that has been picking up for four years. However, the migration flows are still falling substantially short of those expected in an optimal currency area despite the increase in the dynamics. Without these migration flows, though, the scale of unemployment in the periphery would be still higher.¹

Postponed opening of labour market to Eastern Europeans another push factor

The second and, in terms of numbers, more significant source of the recent immigration wave is the countries of Central and Eastern Europe which joined the EU in 2004 and 2007. Germany opened its labour market to citizens from the EU-8 or EU-2 only after a full transition period of seven years had elapsed as of May 2011 and the start of January 2014, respectively. There had already been a boom in migration from Eastern Europe to Germany in advance of

¹ See Bräuninger, D. (2014). The dynamics of migration in the euro area. Deutsche Bank Research. EU Monitor Integration. July 2014.

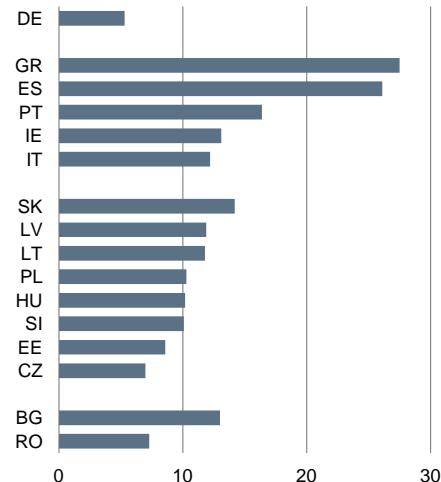


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Labour market hit particularly hard in EMU periphery

3

Unemployment rate (% , 2013)



Sources: Eurostat, Deutsche Bank Research

market deregulation. This was accentuated by the crisis in south-western Europe. The crisis redirected the previously sizeable migration flows from Central and Eastern Europe to the south-western periphery of the Continent back towards the core. This effect was even reinforced by the fact that in the past few years a significant number of south-eastern Europeans had already returned to their home countries owing to the poor labour situation in the south-western periphery. In 2013, a net surplus of 189,400 persons migrated to Germany from these 10 countries. The largest group consisted of Polish nationals, followed by Romanians.

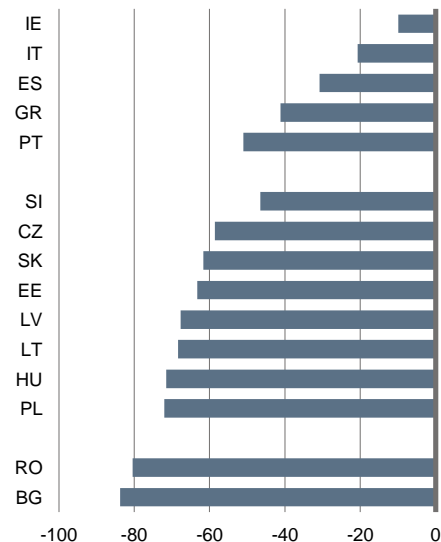
Various migration motives

Combined, nearly 63% of the immigrant total stems from two main regions: south-western and Central and Eastern Europe. More than two-thirds of the total comes from the EU as a whole. Even though most of them are labour migrants, there are various motives for their decision to emigrate. The flows from Central and Eastern Europe as well as south-eastern Europe, where unemployment in many areas had not increased as noticeably over the past few years as in south-western Europe, probably hinged to a great extent on the pronounced differences in wage levels to Germany. By contrast, the new arrivals from south-western Europe have mainly sought to avoid unemployment.

Disposable income: Relatively large gap between Germany and Eastern Europe

4

% (5 year average)



Sources: Eurostat, Deutsche Bank Research

Immigrants are young and far better qualified than they used to be

Immigration in earlier migration phases – such as the "guest-worker" recruitment up to 1973, family reunification until the end of the 1980s, the influx of ethnic German resettlers in the 1990s and political refugees after the Iron Curtain came down – resulted in doubly negative selection in which relatively low-skilled groups moved to Germany while relatively higher-skilled persons emigrated, a trend that in fact became more pronounced in the course of these phases. The integration of the low-skilled in the labour market became increasingly difficult over the past few decades, though, since the demand for low-skilled labour continually fell with the rise in globalisation and the crowding-out effects resulting from the advances of technological change.

By contrast, the immigration phase underway since 2010 reflects a positive selection of immigrants. The share of university graduates among them nearly doubled over the past decade, coming to around 43% at last reading.² Thus it is significantly higher than the share in the German population at large (28%). However, educational attainment is seldom comparable in quality terms, not least because of the special features of the German education and training system. Conversely, the share of the low-skilled (those who have not completed vocational training) nearly halved in the same period, from 41% to 22%. Among German citizens this share comes to only 11%, however.

Nonetheless, qualification levels do differ in country-specific terms. For example, at 25%, the share of the highly qualified among the migrants from Bulgaria and Romania is similar to the share in the German population. However, the share of persons who have not completed vocational training is also relatively high in this migrant group at 35%. By comparison, the qualification structure of the immigrants from south-western Europe is more homogeneous.

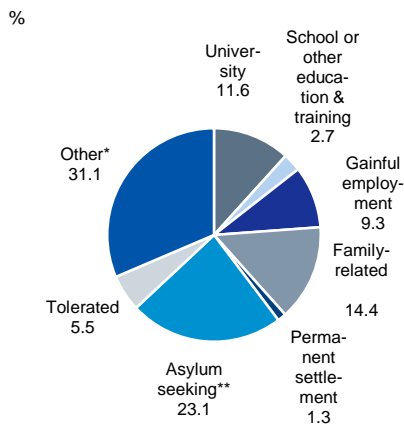
² See Brücker, H. (2014). Profitiert Deutschland von der Arbeitsmarktmigration in der EU? Daten, Fakten und Analysen. Heinrich-Böll-Stiftung (Publ.). Dossier Welcome to Germany I - Fachkräftemigration und Willkommenskultur. June 2014. p. 16f; as well as the literature referred to there.



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Immigration of third-country nationals by purpose of residence, 2013

5



*Family reunification, asylum etc.
**Humanitarian, political or international-law reasons

Source: German Central Register of Foreign Nationals

Generally, the age structure of the immigrants is a favourable feature. The immigrants from European partner countries are only 28 years old on average. This means they could have the effect of rejuvenating Germany's ageing society. The average age of the population in Germany is about 44.

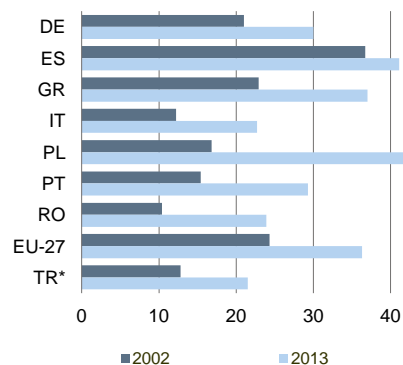
Higher skills level thanks to new home-country mix and increased labour migration

The higher skills level reflects a significant transition in the structure of immigration resulting not only from the euro crisis, but also from institutional changes. Immigration from EU partner countries fluctuated at a low level for many years until well into the second half of the past decade. Migration from third countries, which then also included – at least in terms of the regulatory framework – the countries of Central and Eastern Europe, was marked by the discontinuation of foreign labour recruitment in 1973. The immigration of skilled labour was of only secondary importance, accordingly. Instead, family reunification and humanitarian, political and international-law reasons (asylum seeking) dominated as migration motives. These motives continue to play a significant role in terms of immigration from third countries. Over the past few years, though, residence for the purpose of study and recently also labour migration have gained in importance too.

25 to 34-year-olds with tertiary education

6

Share in cohort (%)



*2006 & 2013

Source: Eurostat

Generally, there are four main reasons why immigrants are better qualified:

1. A generally higher level of educational attainment in the home countries

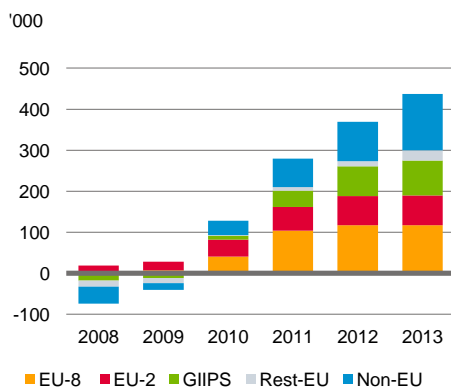
The enormous educational expansion of the past few decades is also feeding through to migration patterns. For example, the share of persons with tertiary education in the EU-27 increased by 8 percentage points, to 25.4%, from 2002 to 2013 alone. In the 25 to 34-year-old age group, that is the cohort which is particularly willing to migrate, this share has in fact increased by no less than 12 points, to 36.3%.

2. The shift in migration flows caused by the euro crisis

In the wake of the euro crisis, immigration from EU partner countries has gained in significance again for the first time in many years. Roughly 20% of all immigrants (net migration balance) came from the GIIPS in 2013. In most cases, these persons have good qualifications.

Net migration to Germany by region of origin

7



Sources: Federal Statistical Office, Deutsche Bank Research

3. The lifting of restrictions on labour mobility for EU partners from Central and Eastern Europe

The end of access restrictions changed the legal status for workers from EU partner countries in Central and Eastern Europe. Since the opening of the labour market to these partners in May 2011 and January 2014, respectively, they are no longer subject to the recruitment ban, but instead now enjoy freedom of movement for workers within the Union. Consequently, the number of (dependent) workers from these 10 countries alone jumped by 148,900 (27.4%) between April 2013 and April 2014. In fact, as regards persons from Romania and Bulgaria, the number of employees grew faster than the number of immigrants in absolute terms, since some of them were already living in Germany. Before the opening of the market, labour immigration from Central and Eastern Europe was mainly confined to relatively low-skilled seasonal workers.

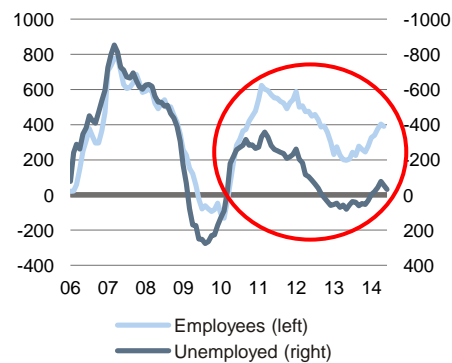


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Strong rise in employment due to higher net immigration since 2010

8

Change yoy, '000 persons



Sources: Federal Employment Agency, Federal Statistical Office

4. The modernisation of the law for third-country nationals

Since 2005 Germany has gradually liberalised its immigration law especially for highly skilled workers from third countries. Academics were granted initially very restricted access to the German labour market. But over time the government steadily eased the restrictions. For example, it relaxed the principle that even highly skilled third-country nationals could only fill job vacancies for which there were no suitable applicants from the domestic or EU partner market – the so-called priority principle. Moreover, the minimum annual compensation that employers had to pay for a job vacancy to be opened to a foreign academic was reduced repeatedly. This development culminated in the implementation of the EU's Blue Card initiative in summer 2012. Since then, the "priority" check for immigrant academics and their spouses has been dropped. The minimum pay level (2014: EUR 47,600)³ is now roughly equal to the salary offered to academics in the lower (entry-level) echelons of the senior civil service, but remains far higher than the average gross wage level of about EUR 31,000. Furthermore, the restrictions on the self-employed from third countries were also lifted. They no longer have to invest a minimum amount of money to set up shop. On top of this, access has been liberalised for non-academic workers in certain sectors where labour is in short supply.

These improvements have an only very limited impact on immigration, though. In 2013 a total of 62,900 third-country nationals were granted a residence permit for the purpose of gainful employment. However, of this total only 28,750 persons actually came to Germany in 2013. The majority of 34,160 had already arrived in the country before 2013.

Immigration of highly skilled workers is good for Germany

The immigration of young and highly skilled workers since 2010 has had a particularly positive impact as the flexibility in this segment of the labour market is relatively high. Since migrants and indigenous workers tend to complement one another, indigenous workers benefit in the medium term from higher wages and lower unemployment, while the immigration of highly skilled workers has a relatively small negative effect on foreigners already working in Germany.⁴

Increased net immigration since 2010 has boosted growth significantly

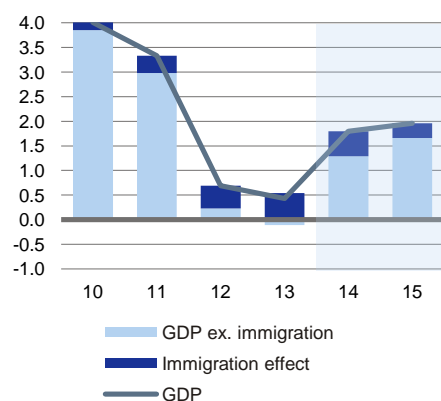
Increased net immigration has led to a continual increase in the size of the workforce since 2011. The cumulative positive net migration balance is 1.2 million persons since 2010, which explains most of the divergence between the hefty rise in employment and the only moderate decline in unemployment in Germany.

This large increase in employment due to immigration has had a significant impact on German economic growth since 2010. The size of this contribution can be determined by breaking down the change in gross domestic product into the changes in employment, working time per employee and hourly productivity. The positive selection of the immigrants group since 2010 has probably helped their integration into the labour market. However, their lack of country-specific knowledge, such as awareness of the specific features of the labour market,

Significant growth effect from immigration

9

Change, % yoy



Sources: Federal Statistical Office, Deutsche Bank Research

³ When an EU Blue Card is issued to scientists, mathematicians, engineers, IT specialists or doctors the applicable threshold is EUR 37,128.

⁴ Brücker, H.; Jahn, Elke J. (2011): Migration and wage-setting: reassessing the labor market effects of migration. In: The Scandinavian Journal of Economics, Vol. 113, No. 2, pp. 286-317.

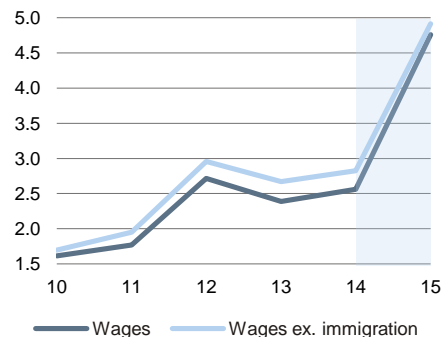


Temporary immigration boom: A wake-up call for politicians?

Net immigration somewhat dampens wage growth

10

Change, % yoy



About half of the expected wage increase in 2015 due to the introduction of the minimum wage (EUR 8.50).

Sources: Deutsche Bundesbank, Deutsche Bank Research

language proficiency and company practices usually makes immigrants less productive when they arrive in Germany than indigenous workers. When migrants are successfully integrated into the labour market their productivity gap diminishes with each additional year in the host country.⁵ Also, the working time of immigrants is lower on average.⁶ This means that between 2010 and 2013 around 20% of the average growth of about 2% was due to the positive impact of immigration. So, on paper, without immigration GDP would in fact have fallen slightly in 2013 instead of growing by 0.4% from a solely supply side perspective.

In addition, with the German labour market in a good state and the initially marked wage disadvantage of foreigners immigration dampens wage growth. Our calculations show that the wage increase would have been at least 0.2 of a percentage point higher without immigration.⁷

Much increased net immigration set to decline in the medium term

The still weak economic recovery in the eurozone with stubbornly high unemployment rates in immigrants' home countries are likely to ensure that immigration from peripheral countries will persist for an extended period. Once the freedom of movement applied to the Eastern European countries (2011/2014) their citizens most inclined to migrate, who are typically younger and more qualified, swiftly left their home countries. Following this initial effect, however, migration should diminish considerably over the next few years.

We expect that net immigration will again total more than 400,000 in 2014 and drop to about 250,000 in 2015. The introduction of the minimum wage will reduce German companies' demand for low-skilled foreign workers, especially in the agriculture and gastronomy sectors, and thus dampen immigration in 2015. Increased net immigration should thus account for around 1/3 of the expected growth of 1.8% in 2014 and about 15% of the growth of 2% in 2015. In the medium term, we expect net immigration to drop to 100,000 per year as the recovery in the peripheral eurozone countries should gradually lead to immigration tailing off and some immigrants returning to their home countries. GDP growth should then be correspondingly lower.

Negative impact of the introduction of the minimum wage and the pensions package partly obscured

The increased net immigration will probably partly obscure the negative effects of the grand coalition's reforms.

The introduction of the minimum wage of EUR 8.50 in 2015 is likely to have a negative employment effect over the medium term of 800,000 persons. The

⁵ Chiswick, B. R. (1978). The Effect of Americanization on the Earnings of Foreign-born Men. *Journal of Political Economy*, Vol. 86 Nr. 5, S 897-921. Borjas, G. J. (1994). The Economics of Immigration. *Journal of Economic Literature*, Vol. 32, No. 4, pp.

⁶ Census data from the Federal Statistical Office was used to make a rough estimate of the share of the workforce and working time and productivity of migrants compared with that of nationals. The negative wage differential for younger age cohorts (and where available from EU countries) was used as a rough approximation of the productivity gap. According to this 75% of the immigrants are employed and the wage disadvantage is 25%. The working time of foreigners is about 5% shorter on account of the different employee structure.

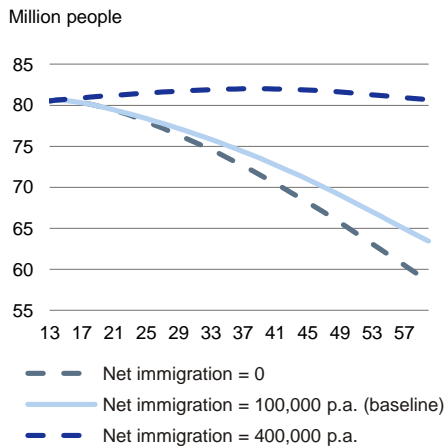
⁷ The effect is calculated using our wage equation, which explains the development in collective wages, based on the core inflation, productivity and unemployment rate movements. Disregarding mismatch problems a calculation is made of how much the unemployment rate would have fallen if the increase in employment had not occurred due to immigration but instead by integrating the unemployed into the labour market. In addition, the low entry-level wages of immigrants probably dampen annual average pay increases.



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Immigration likely to fall again in medium term and population set to contract

11



Assumptions:
1) Birth rate 1.4
2) Life expectancy until 2055:
Men +7.2 years, women +6.6 years

Sources: Federal Statistical Office, Deutsche Bank Research

good economic situation and higher net immigration of highly skilled workers should, however, ensure that the negative effects are not directly visible in the employment trend.⁸

Thanks to immigration the size of the workforce should continue to rise despite the increasing number of early retirees resulting primarily from the pension at 63 option. In addition, the negative impact on the pension insurance scheme is partly obscured by rising contributions paid by immigrants.

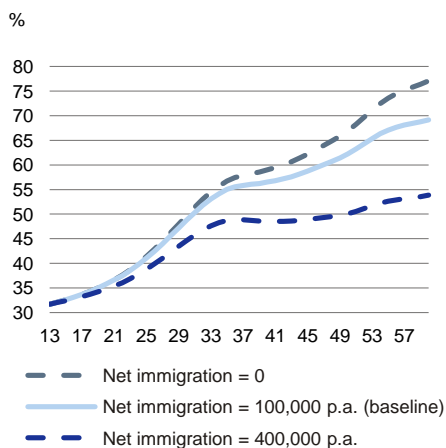
Increased net immigration can only mitigate the huge demographic challenge

The temporary sharp increase in immigration and the continuing positive net migration balance will slightly ease the burden of the huge demographic challenges. The population is likely to contract by around 20% by 2060, the foreigners' share of overall population should roughly double to 20% and the old-age dependency ratio (65+ / 15-64y) should climb from about 30% to around 70%. Even based on an (unrealistic) alternative scenario of a constantly high net immigration of 400,000 persons up to 2060, the population would remain roughly constant, but the foreigners' share would climb to 40% and the old-age dependency ratio to some 55%. This would ease the burden on the pay-as-you-go German pension system, but it would represent a challenge for integration policy that would be very difficult to manage.

Current boom: A wake-up call for politicians?

Old-age dependency ratio (65+ / 15-64y) also continues rising with high immigration

12



Assumptions:
1) Birth rate 1.4
2) Life expectancy until 2055:
Men +7.2 years, women +6.6 years

Sources: Federal Statistical Office, Deutsche Bank Research

The marked increase in immigration is to be welcomed. Germany will derive a significant temporary benefit from the latest surge in immigration. The migration is occurring primarily in the labour market. Accordingly, the German economy is being boosted significantly at the cyclical and employment levels. For the time being, this will mask even the negative consequences of misguided economic policy decisions such as the minimum wage and retirement at 63. The concerns expressed by some about increasing problems arising from poverty-driven migration are not borne out by either our calculations or the immigration facts.

However, the current boom is no reason for self-satisfaction over economic policy, but should instead be interpreted as a wake-up call. The dynamic immigration from the south-west and the east of the EU is due to special factors. It is mainly a reflection of the difficult economic situation in partner EU states and less of Germany having become more attractive. Following the latest boom the trend will not be maintained, but will probably reverse in the course of this year.

The ageing Germany will therefore continue to require immigrant labour from outside the EU. Germany is still not sufficiently prepared for this. There is still a lot to be done to make the country appealing to more highly skilled workers. Although the legal framework especially for the immigration of academics has been liberalised considerably there is still room for improvement. Academics from third countries should thus also be let in if they receive only an average salary (about EUR 31,000 p.a.). It is generally questionable that immigration legislation is tied to the possession of an employment contract. Furthermore, the legislation is too complex. The variety of regulations is virtually impenetrable both for would-be immigrants from third countries and for domestic small and medium-sized businesses as potential employers. Simplified rules such as

⁸ See Peters, H. (2014) Minimum wage of EUR 8.50 per hour: Grand Coalition on the wrong track. Deutsche Bank Research. Focus Germany, June 4, 2014.



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auctions for immigration certificates mainly to manage temporary immigration and a points system for permanent immigration would be the better alternative to the existing forest of regulations.

Given the global "war for talent" even liberal immigration rules will, however, have an only limited effect if the heavy burden of taxes and contributions is not reduced. The large tax wedge of 49.3% between labour costs and net incomes of (single) average earners does not tally with the needs of a country wanting to attract immigrants. Germany thus ranks lowest in the OECD alongside Belgium. Lots of highly skilled workers therefore give Germany a wide berth.

If Germany is to become more attractive to highly skilled foreigners, the language barrier must no longer be so high. For instance, small and medium-sized firms need to become more willing to hire English-speaking skilled personnel.

It is also important to efficiently deploy those immigrants who are already in Germany. This requires further improvements – also in company hiring practices – in recognising qualifications gained abroad. But the issue is also about less skilled workers. They, however, have been done a disservice by the introduction of the minimum wage.

Immigration can help to considerably reduce bottlenecks in the labour market. It is, however, not a panacea against the demographically driven upheavals in the labour market, the pensions system and healthcare. Structural reforms to boost the flexibility of employment, increase participation rates of older workers and women with children, raise the (actual) retirement age again and increase private provision for old-age therefore remain on the agenda.

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