Economic Note

Q3 2017 Labour Market Preview

27 October 2017

Wages on the rise, OCR going nowhere for a while yet

- We expect to see HLFS employment rebound from its Q2 dip, with the Q3 unemployment rate expected to ease to 4.7%, its lowest since 2008.
- Pay equity settlements are expected to push annual LCI wage inflation to 1.9%, a three-year high. The bias is for a modest strengthening in wage inflation despite slowing employment growth.
- Firming LCI wage inflation should dispel the notion of OCR cuts, whilst considerable uncertainties on the outlook and policy backdrop are expected to encourage continued inaction on OCR settings.

Q3 Labour Market Forecasts		
Indicator	ASB	Prior
Employment growth (QoQ)	0.9	-0.1
Unemployment Rate (%)	4.7	4.8
Participation Rate (%)	70.2	70
Labour Cost Index		
Private Sector (%, QoQ)	0.7	0.4
Private Sector (%, ann)	1.9	1.6

Summary & implications

We expect employment from the household labour force survey (HLFS) to increase by 0.9% qoq in Q3 (2.6% yoy), driven by some recoil from 0.1% Q2 dip. A more modest climb in the labour force participation rate (to 70.2%) is expected to push down the unemployment rate to 4.7%, a nine-year low. Low levels of labour underutilisation should confirm the labour market remained tight in Q3.

Following a run of low quarterly outturns, pay equity Settlements for health care and support workers are expected to lift private sector labour cost index (LCI) wages by 0.7% qoq in Q3, with annual wage inflation firming to 1.9%. Further pay equity increases, pending increases in the minimum wage and the still tight labour market are expected to see annual LCI wage inflation gradually firm over the next few years.

The prospect of LCI wage inflation moving above the inflation target midpoint should dispel the notion of OCR cuts. Given the considerable uncertainties on the outlook and a still-fluid government and monetary policy backdrop, the RBNZ are expected to sit tight for a while yet.

We expect overall HLFS employment growth to increase 0.9% qoq in Q3, with the annual employment growth slowing to 2.6%. The Q3 labour market release is the fourth quarterly release since the HLFS survey was redeveloped and while the changes were intended to provide more comprehensive coverage of the labour market they do not appear to have completely eliminated quarterly volatility. The Q2 dips in employment and workforce participation look to be anomalous given still-solid survey employment intentions and the reported 0.7% qoq climb in filled jobs from the Quarterly Employment Survey (QES)

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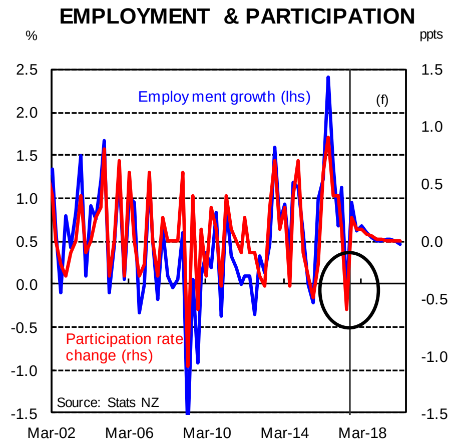
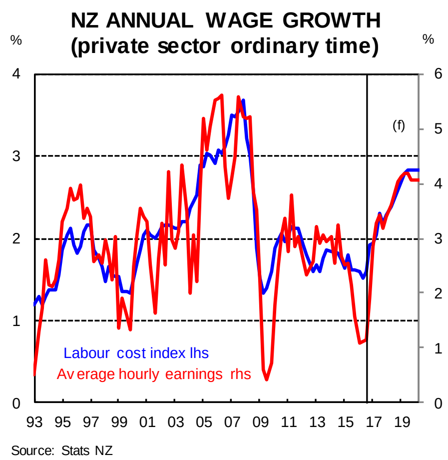
As such, we suspect some statistical payback is on the cards for the HLFS employment print, with a small climb also expected for surveyed labour force participation from the HLFS, with the latter expected to firm to 70.2% of the labour force, the third highest on record. On account of larger increases for employment than participation, the HLFS unemployment rate is expected to ease to 4.7% in Q3, its lowest level since 2008Q4. Even if the unemployment rate does not fall, **historically high levels of labour force participation and potential declines in the already very low labour underutilisation rate** (which in Q2 was at its lowest level (11.8%) since 2008) **should confirm that the labour market is tight.** HLFS hours worked and QES paid hours (the latter of which is a key input into Q3 GDP) are expected to register more moderate quarterly increases, consistent with our view of a moderation in GDP growth over the second half of 2017.



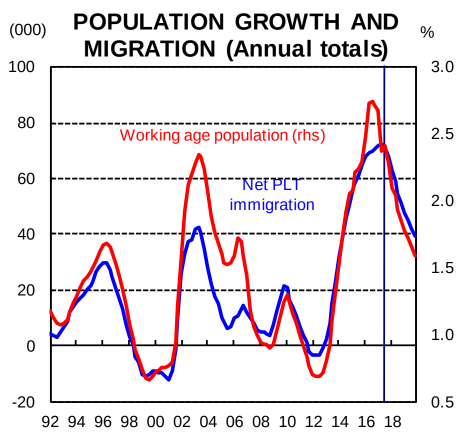
One of the puzzles of late has been why wage inflation has remained so low this cycle. Globalisation (low wage inflation is not a NZ-specific phenomenon), low headline rates of NZ CPI inflation (modest indexation for wages) and strong competition for jobs look to have played a key role in tempering wage increases.

Following a run of eight consecutive 0.4% qoq increases, the impact of the July pay equity settlement for health care workers should help push up LCI wage inflation, which we expect to strengthen to about 0.7% qoq for private sector wage rates (+1.9% y/y), and 0.8% qoq for public sector wages (+1.8% yoy). We expect private sector average hourly earnings growth from the Quarterly Employment Survey measure to firm to 1.9% yoy, a 15-month high.

Moreover, cost-push influences and government policy changes are expected to underpin wage growth going forward. Our back of the envelope estimates of the first round impacts from the pay equity settlements and minimum wage increases suggest they will add 0.3-0.5% to annual wage inflation over the next few years. The full impact on wages could be larger if this spills-over to wage demands in other sectors. There will be considerable pressure on the new coalition government to contain public sector wage settlements, whilst private sector employees will also find they may have their work cut out for them in retaining key staff.



A combination of demand and supply-side factors are expected to temper employment growth in the years ahead. Employment tends to lag the economic cycle, and while we expect GDP growth momentum to slow over the remainder of 2017, it will take time to translate into hiring decisions. The expansion has entered the mature phase of the cycle and some of the drivers look to be at (or past) their peaks, including net immigration, the housing market, the terms of trade and potentially tourism inflows. The improving global scene, expansionary fiscal policy, historically-low interest rates and the lower NZD should ensure that any slowdown in activity is fleeting**, but there is still considerably uncertainty over the economic outlook in the current juncture.**



On the supply side, our expectation of a tailing off in net PLT immigration from around 70,000 persons per annum at present to around 40,000 persons over the next two years will knock at least 0.5 percentage points per annum off working age population growth going forward. A smaller pool of available workers will not be helpful for alleviating widespread capacity constraints within the economy and addressing challenges firms are facing in finding the "right" person for the job.

The modest shift in economic direction signalled by the new coalition government will likely result in regional and sector winners and losers. Given the new collation government is in its infancy exact details remain scant. Enhanced focus on regional development could provide a much-needed boost to employment in some regions where the unemployment rate has persistently been above the nationwide average (i.e. the BOP and Northland). Employment in the capital should also do well. Still ambitious targets for dwelling construction and wider infrastructure investment suggest still strong demand for construction sector workers although we are cautious given risks to the NZ population outlook and the flow-on effects of the softening housing market.

Market reaction and policy implications

The labour market reports will be the last significant domestic data release before the Reserve Bank's November Monetary Policy Statement (November 9). Given that the August MPS forecasts had already signalled a slight fall in the unemployment rate and a temporary boost to wage growth is unlikely to trigger a shift in viewpoint from the RBNZ, confirmation of this is unlikely to trigger a persistent shift in market pricing or the NZD.

There are much bigger issues for the RBNZ to consider in terms of the economic outlook and the potential operation of monetary policy but we expect the Bank to stick to its knitting and avoid signalling any change in view until further details emerge. **Our core view remains for the OCR to remain on hold until at least 2019.**

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