Economic Note

31 July 2019

RBNZ to pick up the (labour market) slack?

- A view on labour market capacity is becoming critical in thinking about how low NZ interest rates could go.
- Our work suggests there is more slack in the labour market than conventional estimates suggest, and the degree of slack looks set to increase.
- All else equal, this necessitates more policy support and we expect at least another 50bps of OCR cuts this cycle.

Summary and implications

Labour markets are currently front and centre for central banks. The RBA's recent lowering of its estimate of full employment proved to be critical in its decision to slash its cash rate. We're attuned to the risk a similar dynamic plays out in NZ.

We believe the NZ non-accelerating inflation rate of unemployment (NAIRU) could be as low as 4%. With the current HLFS unemployment rate at 4.2%, this suggests the unemployment 'gap' is close to zero. In other words, the labour market is not nearly as tight as many would think. Similar conclusions can be drawn from the range of alternative labour capacity measures we examine in this note.

We expect the recent downtrend in the NAIRU to remain in place. And with labour demand cooling, the degree of slack in the labour market looks set to pick up. This is potentially a big deal for the monetary policy outlook and we suspect the RBNZ will be looking at these dynamics more closely. More policy support is needed and we expect the 1.5% OCR to be lowered at least another 50bps this cycle.
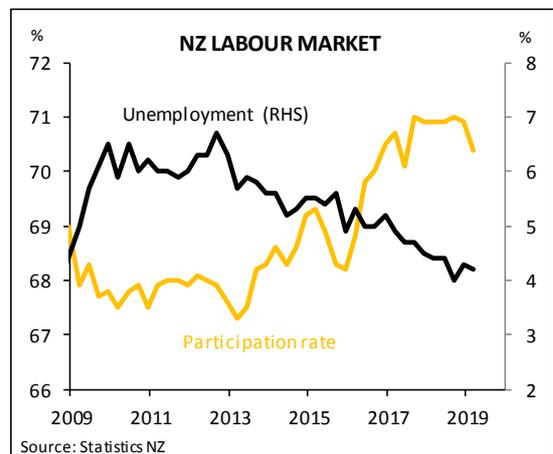
Labour Markets to the Fore

Labour markets are currently front and centre for central banks.

The Reserve Bank of Australia (RBA) recently changed its view about the degree of slack in the Australian labour market. It's lowering of the estimated 'full employment' rate to around 4.5% implied there was much more spare capacity in the labour market than previously thought, given the prevailing unemployment rate of over 5%. This was key in the RBA's decision to lower its cash rate 50bps over June and July.

The Reserve Bank of NZ (RBNZ) now has an explicit labour market target – Maximum Sustainable Employment (MSE). The Bank has basically claimed victory on this front. And fair enough. The unemployment rate in NZ is a very low 4.2% (c.f. Australia's 5.2%) and the participation rate is close to record highs, at around 70%.

But signs of unease have crept in lately. At its June 2019 OCR review, the Bank noted the absence of wage pressure "could indicate there is still spare capacity in the labour market". In other words, MSE could actually be higher, and the neutral unemployment rate lower, than where we are now. The implication would be more work to do for the RBNZ to achieve its MSE target. A timely view on labour market capacity is critical in
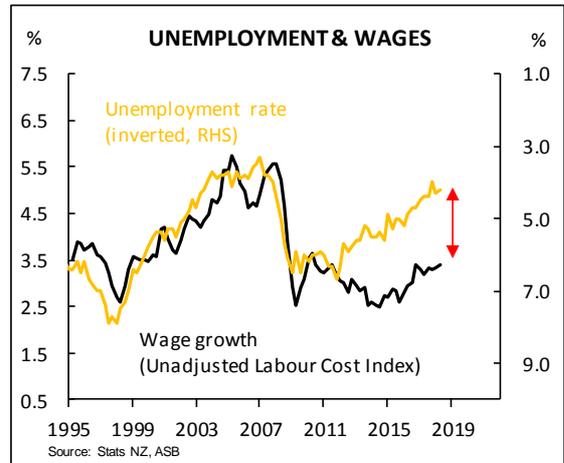

Source: Statistics NZ

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thinking about the outlook for NZ interest rates.

Can't we just look at the unemployment rate?

Both the RBA and RBNZ are increasingly of the view that the unemployment rate alone is too narrow a measure of labour market capacity. We concur.

Looking at a broader array of capacity measures may also provide some insight into why the unemployment rate and wage growth have diverged to such a degree. Wage growth has not picked up to anywhere near what the historical relationship with the unemployment rate would suggest (see chart).

Below we take a look at what a few different indicators are saying about NZ labour market capacity.
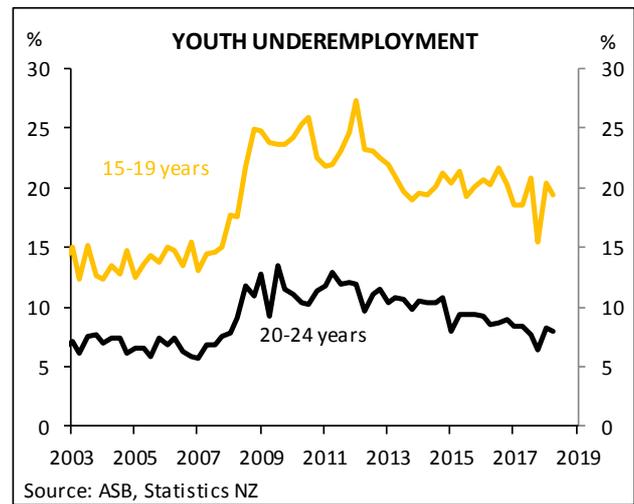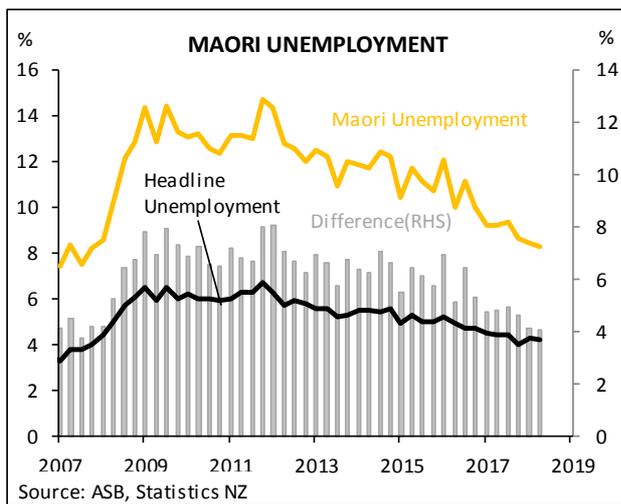
UNEMPLOYMENT & WAGES

Unemployment rate (inverted, RHS)

Wage growth (Unadjusted Labour Cost Index)

Source: Stats NZ, ASB

Labour market capacity measures

(1) **The unemployment gap.** This is the gap between the headline unemployment rate and some equilibrium measure of unemployment, usually a NAIRU estimate. The size of the gap gives us an idea about the amount of capacity in the labour market, and hence pressure (or otherwise) on wages and inflation.

We estimate that the NAIRU is currently hovering just above 4%, the bottom of the RBNZ's recently estimated range (4.0-5.5%). With the current HLFS unemployment rate at 4.2%, a NAIRU of 4% suggests the unemployment gap is currently around zero. In other words, the labour market is neither particular tight nor loose. This is of course quite a change from a few decades ago when a 4% unemployment rate would indicate a super tight labour market and strong pressure on wages to rise.
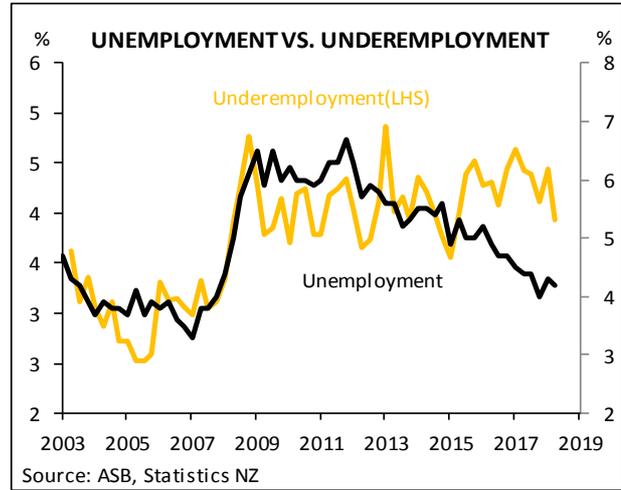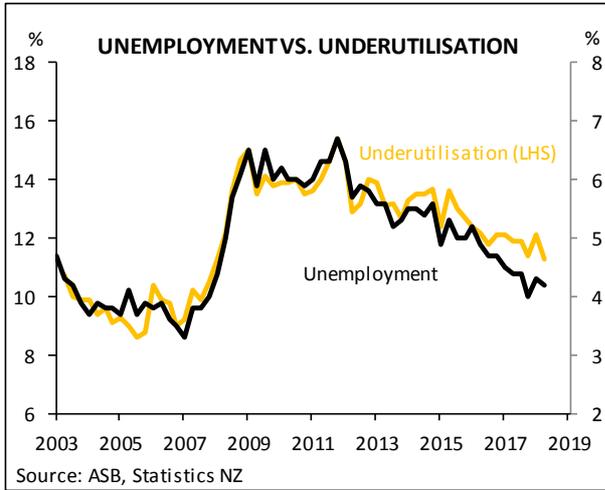
(2) **Broader HLFS capacity measures.**

The RBNZ recently released a [paper] summarising its own research into broader indicators of labour market capacity. The best of the 44(!) tested were found to be: the Maori unemployment rate and its deviation from headline unemployment, youth unemployment rates and their deviation from headline unemployment, a traditional unemployment gap model, the underutilisation rate[1], and the underemployment rate[2].

MAORI UNEMPLOYMENT

Maori Unemployment

Headline Unemployment

Difference(RHS)

Source: ASB, Statistics NZ

YOUTH UNDEREMPLOYMENT

15-19 years

20-24 years

Source: ASB, Statistics NZ

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[1] A broad group considered part of the potential labour supply. Includes underemployed workers, unavailable jobseekers, and available potential jobseekers.
[2] Part-time worers who would prefer to work more hours and are available to do so.

UNEMPLOYMENT VS. UNDERUTILISATION

Underutilisation (LHS)

Unemployment

Source: ASB, Statistics NZ

UNEMPLOYMENT VS. UNDEREMPLOYMENT

Underemployment(LHS)

Unemployment

Source: ASB, Statistics NZ

These are measures that are sensitive to the general business cycle and hence do a better job of explaining employment, wage growth and core CPI inflation than the unemployment rate alone. Indeed, while headline unemployment has trended steadily lower from its post-GFC highs, this batch of measures provides a slightly more mixed picture of labour market capacity (see charts above). Youth unemployment, for example, has not really improved to any material degree since the GFC. Labour force underutilisation and the underemployment rate also haven't fallen to the same extent as the unemployment rate in recent years.

We've combined these indicators into one summary measure, which we can then build an unemployment gap model around. We've termed this the 'broader NAIRU' (chart opposite). While the broader NAIRU is materially higher than the traditional NAIRU, the NAIRU gap is similar to the traditional gap in currently being very close to zero (see chart overleaf).

LABOUR MARKET CAPACITY AND NEUTRAL OCR

NAIRU
Broader NAIRU
Neutral OCR

Source: Statistics NZ, ASB
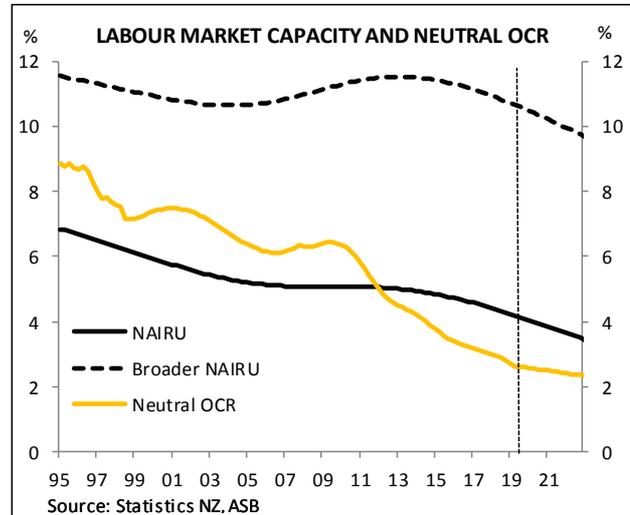
(3) QSBO is the best of the rest

We are wary of putting all our eggs in one basket given the short shelf life of previous efforts to construct single indicators summarising labour market capacity (for example the RBNZ's LUCI). The volatility of HLFS metrics also suggests it would be prudent look at alternatives.

We examined a swathe of measures from a range of sources and concluded that the labour utilisation measures from the QSBO tend to provide the most useful information about the degree of stretch in the labour market. We've put together a composite measure of labour market capacity (QLMC), which is a combination of three QSBO series: skilled and unskilled labour shortages and the extent to which shortages of labour are a constraint on production.[3]

Our testing (see Appendix 1 for details) confirms that both the HLFS-based measures of labour market capacity in (1) and (2), and the QSBO data are statistically causal indicators of the degree of resource stretch within the economy, and of movements in wage and general wage inflation. In fact, the labour utilisation gap obtained from the QLMC, tends to *lead* the other capacity-based measures. Overall, the QLMC tends to paint a broadly similar

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[3] Statistical tests suggest the presence of a structural break within the QSBO capacity measures, so we have adjusted the trend values for the inputs into the QLMC higher, post the GFC. This has minimal impact on the overall results.

picture of current labour market capacity as the measures discussed earlier.

What does it all mean?

All of the labour capacity measures we have looked at imply the labour market is not as tight as what looking at the unemployment rate alone would suggest. This suggests that the economy's Maximum Sustainable Employment (MSE) could be higher than most think.

What is perhaps more important is the outlook. Trends in both the traditional NAIRU and the broader NAIRU are shifting downwards, similar to the experience of Australia and other OECD countries. We expect these downward trends to remain in place (see chart opposite).

With our forecasts suggesting the unemployment rate will likely rise towards 4½% next year, the degree of slack in the labour market looks set to pick up. This tends to accord with our estimate of the economy-wide output gap, which we also expect to move into negative territory over the next few years.

The last word goes to…productivity

Even a simple eye-balling of the charts shows that no one labour market capacity proxy can fully explain the movements in wage inflation of the past ten years. Statistical tests prove this to be the case. Something else is going on.

Our previous analysis pointed towards labour productivity growth, CPI inflation, and structural change in the labour market as important drivers of wages, in addition to capacity pressures.

CAPACITY MEASURES AND WAGES

Legend:
- Broader NAIRU gap
- NAIRU gap
- QSBO Indicator (QLMC)
- LCI Wage Inflation (unadjusted), rhs

Source: Statistics NZ, ASB, NZIER

CAPACITY MEASURES

Legend:
- Output Gap
- Broader NAIRU gap
- NAIRU gap

Source: Statistics NZ, ASB

Broadly, what we have seen is a fundamental change in the capacity and inflation trade-off, not just in the labour market but economy-wide. It could be that increased globalisation and technological change are facilitating a shift in these trade-offs, which likely explains why inflation both here and abroad has been so low despite historically-low rates of unemployment and elevated measures of resource utilisation. If this disconnect persists it will have significant policy and market implications that we will expand upon in a forthcoming note.
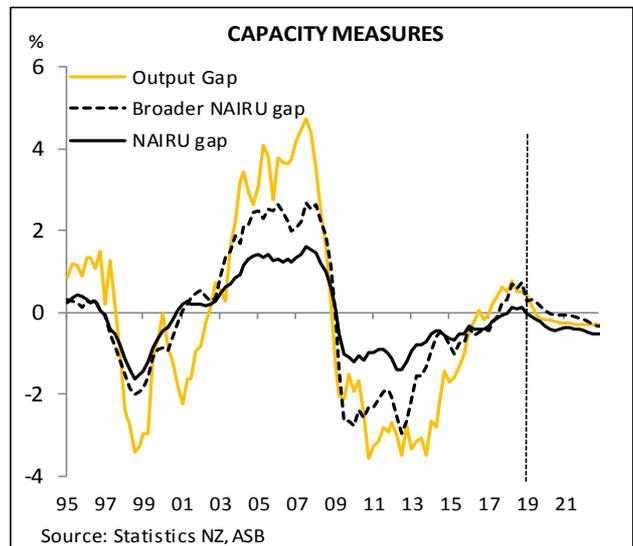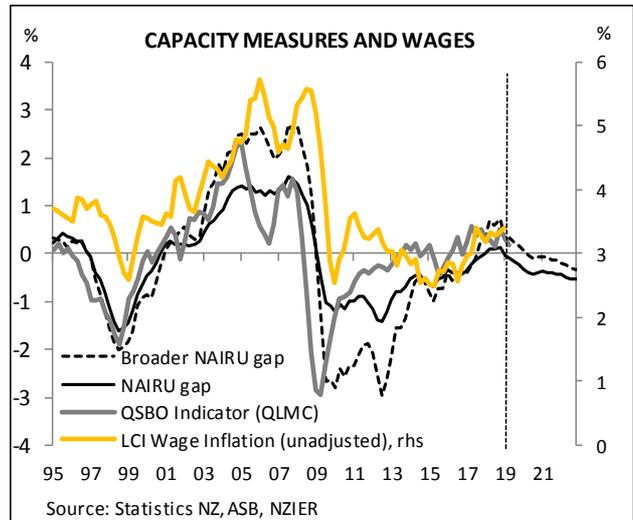
Appendix 1: Granger Causality tests

Variables

CPIXG = Annual CPI inflation ex GST
CPIEXP = Expected CPI inflation (2-years-ahead, RBNZ survey of expectations
Core CPI = Annual inflation from the RBNZ Sectoral Factor Model
LCI = Private sector salary and wage rates (Annual inflation), Labour Cost Index
LCIUN = Unadjusted LCI (Annual wage inflation, all sectors)
PNT = Annual non-tradable CPI inflation (ex-GST)
UGAP = Unemployment gap (ASB estimates)
QSLS = Skilled labour shortages (QSBO)
QULS = Unskilled labour shortages (QSBO)
QLLF = Labour as a limiting factor (QSBO)
QLMC = QSBO labour capacity measure
WUGAP = Wider Unemployment gap (ASB estimates)
YGAP = Output gap (ASB estimates)
TWI = NZD Trade-weighted index (RBNZ)

GRANGER CAUSALITY TESTS

Independent Variable / Dependant Variable

1995-2019	CPIXG	CPIEXP	CORECPI	LCI	LCIUN	PNT	UGAP	WUGAP	QSLS	QULS	QLLF	QLMC	YGAP	TWI
CPIXG		***	-	***	-	-	-	-	-	-	-	-	-	-
CPIEXP	*		-	**	**	-	-	**	-	-	-	-	-	-
CORECPI	***	-		***	***	**	**	**	*	-	-	-	-	-
LCI	-	-	-		**	*	-	**	**	**	*	-	-	-
LCIUN	***	-	*	**		**	-	-	-	-	-	-	-	-
PNT	-	-	-	-	-		-	-	-	-	-	-	-	-
UGAP	***	-	*	***	***	**		***	-	-	-	-	-	-
WUGAP	*	-	-	***	***	-	-		-	-	-	-	**	-
QSLS	-	-	**	***	***	-	***	***		-	***	**	**	-
QULS	**	-	*	***	***	**	***	***	-		***	-	***	-
QLLF	-	-	*	***	***	-	***	***	**	***		*	**	-
QLMC	-	*	**	***	***	**	***	***	***	***	***		***	**
YGAP	**	-	**	***	***	**	***	***	-	-	-	-		-
TWI	*	**	-	**	**	*	-	*	-	-	-	-	***	

Source: ASB. Significant at the 1% (***), 5% (**) and 10% (*) levels respectively

GRANGER CAUSALITY TESTS

Independent Variable / Dependant Variable

2010-2019	CPIXG	CPIEXP	CORECPI	LCI	LCIUN	PNT	UGAP	WUGAP	QLMC	YGAP
CPIXG		-	*	***	-	-	**	**	-	-
CPIEXP	-		-	*	**	-	-	-	-	**
CORECPI	**	-		*	-	-	**	-	-	**
LCI	**	-	-		-	-	-	-	-	***
LCIUN	-	-	-	***		***	*	-	-	**
PNT	*	**	-	-	*		-	-	**	*
UGAP	-	-	*	*	-	-		***	-	-
WUGAP	-	-	-	*	-	-	**		-	*
QLMC	**	-	-	-	-	-	-	-		-
YGAP	**	***	***	**	-	-	**	-	-	

Source: ASB. Significant at the 1% (***), 5% (**) and 10% (*) levels respectively

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