ASB

Economic Note

Q2 2018 Labour Market Preview

26 July 2018

One tick, but not two (yet)

- The higher minimum wage is expected to deliver a 0.6% qoq increase in the Labour Cost Index (LCI), with annual LCI wage inflation for the private sector rising to a six-year high. Risks to this pick are tilted to the downside and we expect the broader wage inflation backdrop to remain contained for now.
- Measures of labour market utilisation should remain elevated, with a moderate quarterly increase expected for employment and with the unemployment rate hovering around 9-year lows.
- A firming trajectory for wage increases and the still-tight labour market should keep the bias tilted towards a higher OCR. But the RBNZ has considerable flexibility at its disposal and a low inflation starting point – we don't expect the RBNZ to raise the OCR until the end of next year.

Q2 Labour Market Forecasts

Household labour Force Survey	ASB	Prior	RBNZ
Employment growth (QoQ)	0.5	0.6	
Employment growth (YoY)	3.7	3.1	
Unemployment Rate (%)	4.4	4.4	4.4
Employment Rate (%)	67.7	67.7	67.9
Participation Rate (%)	70.8	70.8	
Labour Cost Index			
Private Sector (%, QoQ)	0.6	0.3	0.6
Private Sector (%, ann)	2.1	1.9	2.1

Summary & implications

- We expect Q2 labour market data to be solid, with a 0.5% qoq increase in Q2 employment from the Household Labour Force Survey (HLFS). Measures of labour utilisation are expected to depict a tight labour market backdrop, with the unemployment rate its lowest in close to a decade and with labour force participation and the employment rate at (or close to) historical highs.
- Increases in the minimum wage are expected to help deliver a 0.6% qoq increase in LCI wages, with private sector annual LCI inflation rising to 2.1%. Despite the lift, distributional measures are expected to depict a generally contained wage inflation backdrop.
- The RBNZ is likely to be happy to see the employment market in such solid shape. The RBNZ clearly looks to be meeting its PTA objectives in terms of "supporting maximum sustainable employment within the economy".
- We suspect that we are getting close to an inflexion point for wage inflation, but the RBNZ will want to be sure that wage growth will continue to strengthen before contemplating an OCR hike. To us this still looks to be a late 2019 story.

Mark Smith – Senior Economist (649) 301 5657 mark.smith4@asb.co.nz

Nick Tuffley – Chief Economist (649) 301 5659 nick.tuffley@asb.co.nz

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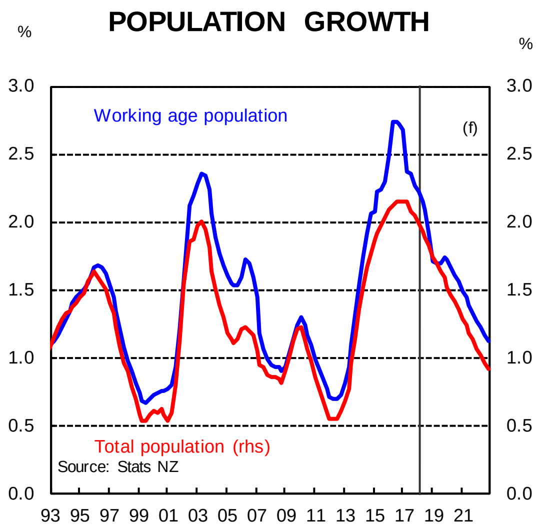
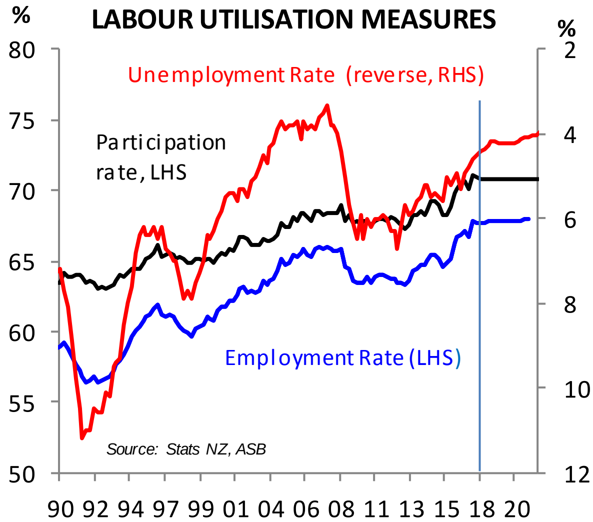
Labour market expected to remain tight

We expect overall HLFS employment to post a moderate 0.5% qoq increase in Q2 2018, with annual employment growth rising to 3.7%, an addition of more than 90,00 jobs. Other published employment measures, including filled jobs and paid hours from the Quarterly Employment Survey (QES) should post moderate annual growth rates. The NZIER Quarterly Survey of Business Opinion showed an increase in the net balance of respondents that had increased staffing over the June quarter, **but there is the risk that the softening implied by surveyed employment intentions from the QSBO and the ANZ Business Outlook flows though into hiring more quickly than suggested by historical relationships.** We nonetheless expect annual employment growth to slow towards 2% by the end of the year.



Still-strong growth in the working age population has made it possible for increasing labour demand to translate into more employment. Earlier published figures from Statistics New Zealand confirmed that the working-age population increased by 0.5% in Q2, with the annual growth at a still-elevated 2.2%, an addition of just over 80,000 persons over the last 12 months, fractionally below the 2.3% growth rate assumed in the May Monetary Policy Statement (MPS). **The growth rate in the working age population is on a moderating trajectory** – it peaked at just under100,000 persons in the September 2016 year, and has broadly tracked the slowing in permanent and long-term (PLT) immigration. Growth in the working age population is expected to progressively slow to around 1.7% over the 2019 year and 1.5% per annum in 2020, in line with the May MPS view.

The strong demand for labour and prospect of firmer wages is expected to encourage strong attachment to the labour market. Indeed, we expect the HLFS participation rate (currently 70.8% of the labour force) and the employment rate (67.7% of the working age population) to remain elevated over the next few years. With a **solid outlook for employment, we expect that capacity pressures within the existing labour market will gradually intensify, with the unemployment rate moving towards the low 4's by the end of next year.** The unemployment rate is expected to remain at around nine-year lows, although risks are tilted towards a lower unemployment rate if participation declines or the improvements in labour productivity we expect fail to materialise.

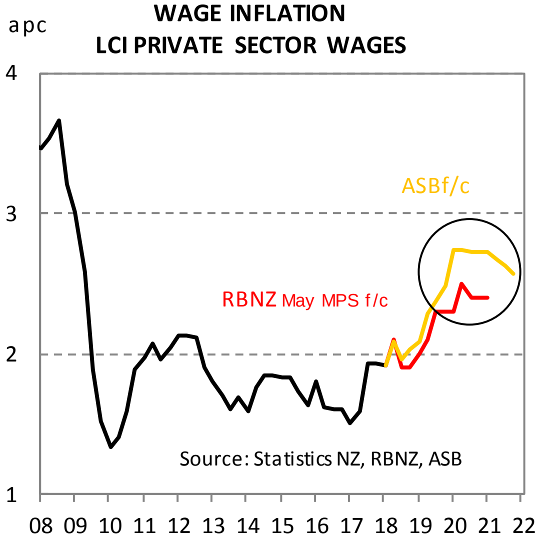


Wages poised to stir

As such, we expect a 0.6% quarterly increase in LCI wages, broadly on par with RBNZ expectations. Annual private sector wage inflation from the LCI is expected to firm to 2.1%, the highest since mid-2012. The April 2018 increase in the minimum wage (to $16.50 per hour from $15.75) is expected to contribute approximately 0.1-0.2 percentage points to annual wage inflation. To date wage inflation has been modest for this stage of the cycle as low headline CPI inflation and strongly growing labour supply have helped to contain wage growth.

For now, we expect the distributional measures to depict a still-benign wage inflation backdrop outside of a few pockets. Recall that the 2018Q1 LCI report confirmed that only 34% of salary and wage rates had achieved a wage increase above 2% over the last 12 months, with close to half reporting no annual increase. Median and mean increases from the LCI are expected to remain relatively mild at around 2.5% yoy.

As we have noted previously, however, we suspect **that we are getting close to another inflexion point for wage inflation. Over the next few years, we expect increases in the minimum wage to outpace other wage increases.** There will also be a flow-on to other wages as workers attempt to preserve relativities. Our provisional estimates suggest that the minimum wage increases and the Fair Pay Agreements could be the catalyst which would add up to 0.5 to 1.0 percentage points per annum to wage inflation through to mid-2022. Annual private sector wage inflation is expected to move above 2½% per annum from late 2019/early 2020, which should see domestically-generated inflation follow suit and the RBNZ respond by lifting the OCR. Our outlook for wage inflation is somewhat firmer than the RBNZ's May projections.



Market reaction and policy implications

The labour market report is published on Wednesday, August 1, one week before the Reserve Bank's (RBNZ) August Monetary Policy Statement (MPS) on August 9. This is the second MPS under new Governor Adrian Orr and the new Policy Targets Agreement (PTA) which has added the requirement of the RBNZ to aim towards "supporting maximum sustainable employment within the economy".

We expect the Q2 labour market prints to confirm that the **labour market is in little need of additional policy stimulus.** We expect that the unemployment rate will remain low and in the middle of RBNZ's 3.5%-5.3% corridor of estimates for the Non-Accelerating Inflation Rate of Unemployment (NAIRU). Moreover, labour force participation and the employment rate are expected to remain at historically-high levels.

Our focus is on the outlook for wages, a key influence underpinning core inflation. In combination, the tightening in capacity pressure, increases in the minimum wage, and rising headline inflation are expected to increase wage growth over the next few years. Current market pricing – where odds are tilted towards a lower OCR by the end of the year – does not look consistent with our view that there is a high hurdle to an OCR cut. By the same, token, however, the RBNZ will be mindful on not moving too quickly given the low inflation backdrop and would be keen to make more use of the flexibility provided to them from the new monetary policy framework. **We expect the OCR to start moving up from November 2019, but that OCR moves will be gradual, with a historically-low OCR endpoint this cycle.**

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	Jane.turner@asb.co.nz	(649) 301 5957
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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