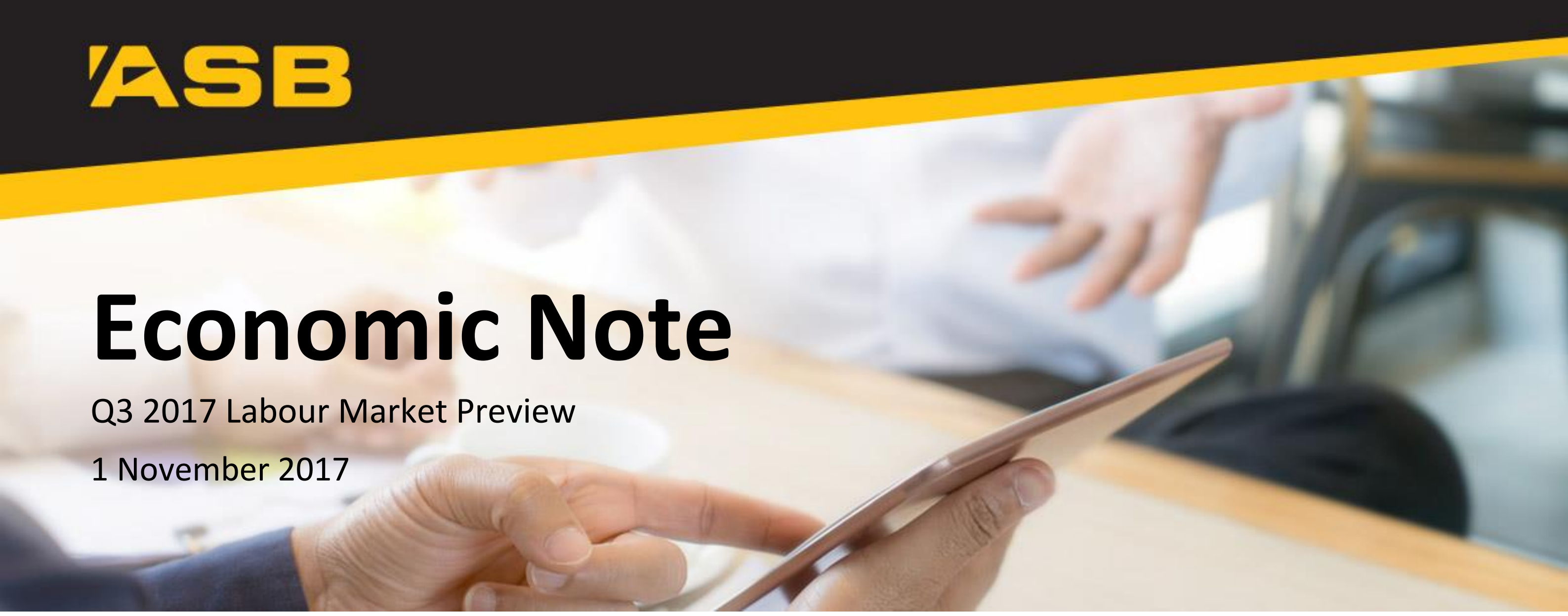

Economic Note

Q3 2017 Labour Market Preview

1 November 2017

Labour market tight but only moderate wage increases

- The Household Labour Force Survey (HLFS) confirmed a surge in Q3 employment, with the unemployment rate falling to a 9-year low. Measures of labour utilisation at historically-high levels, with both the employment (67.8%) and labour force participation rate (71.1%) hitting record highs.
- Pay-equity settlements push up annual private sector Labour Cost Index (LCI) wage inflation to a 5-year high, but there were few signs of widespread wage pressures. Announced increases in the minimum wage are expected to herald the start of a period of rising wage inflation.
- A benign backdrop for core inflation and sub-trend short-term growth outlook suggest no immediate need for the RBNZ to deviate from its on-hold stance. However, like us, the RBNZ will be closely following developments in wage inflation for guidance on future OCR moves.

Indicator	Actual	ASB	Market
Employment growth (QoQ)	2.2	0.9	0.7
Unemployment Rate (%)	4.6	4.7	4.7
Participation Rate (%)	71.1	70.2	70.2
Labour Cost Index			
Private Sector (%, QoQ)	0.7	0.7	0.6
Private Sector (%, ann)	1.9	1.9	1.8

Summary & implications

The Q3 surge in the HLFS took almost everyone by surprise, and confirmed that quarterly volatility remains alive and well despite changes to the survey. Taking the numbers at face value, the general take-out is that the kiwi jobs machine is working overtime (employment rose by more than 100,000 jobs over the past 12 months), which is placing considerable pressure on the ability of the economy to supply the necessary workers. Measures of labour utilisation have generally firmed to record highs.

Following a run of low quarterly outturns, pay equity settlements for health care and support helped to push to annual private sector wage inflation on the LCI to a five year high (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. But, for now at least, there are few signs of generalised wage increases emerging into the wider labour market, where wage inflation remains contained.

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

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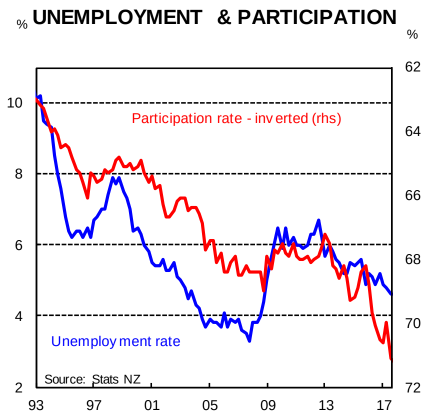
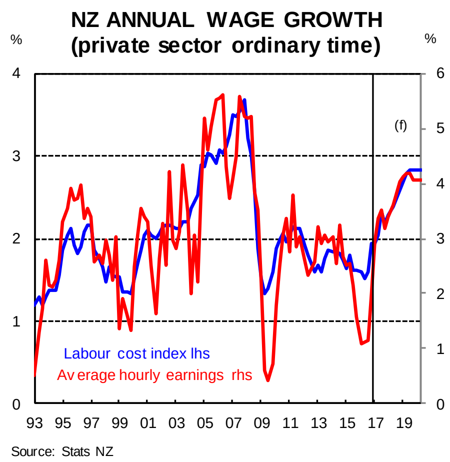
The Q3 labour market release was the fourth quarterly release since the HLFS survey was redeveloped. Although the changes were intended to provide more comprehensive coverage of the labour market, they do not appear to have completely eliminated quarterly volatility. **HLFS employment surged 2.2% qoq in Q3 (4.1% yoy), much stronger than the 0.8% qoq market consensus.** Hours worked from the HLFS also rose strongly (+2.4% qoq, +4.5% yoy). The economy added 103,000 jobs over the last 12 months, a stunning achievement considering that the working age population increased by less than 90,000 persons over that period.

+The Q3 increase needs to be put into context in that it followed the flat Q2 outturn. Moreover, **Increases in employment were more moderate from the Quarterly Employment Survey (QES) measure,** with filled jobs rising by just 0.2% qoq (2.5% yoy). Moderate increases in paid hours, which rose by 0.8 qoq on Q3 (3.0% yoy) **are broadly consistent with our expectations of a moderation in overall economic activity in the second half of this year.**

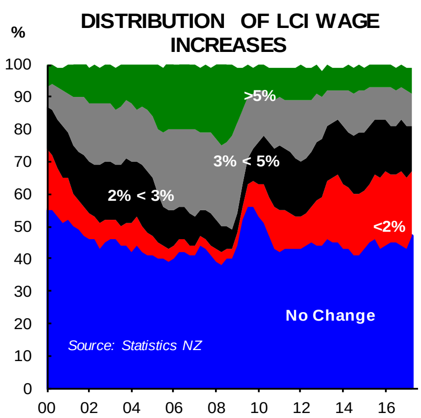


The HLFS unemployment rate fell to 4.6% of the labour force, the lowest level since 2008Q4. The tight labour market was corroborated by other measures. The labour force participation rate firmed to 71.1% of the working age population, whilst the employment rate (those employed as a share of the working age population) rose to 67.8%, **with both hitting record highs**. Moreover, the seasonally-adjusted underutilisation rate (a measure of slack within the existing employment market) remained steady on 11.8%, the lowest since 2008Q4.



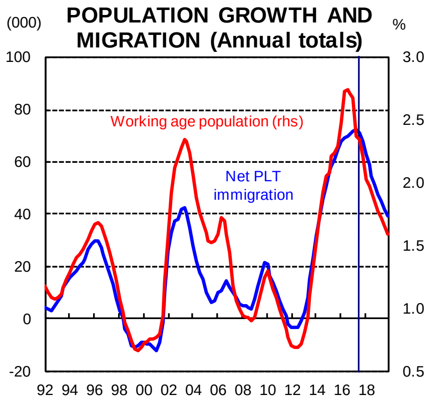
The Q3 report confirmed a firming in aggregate wage inflation, with increases of 0.7% qoq for private (1.9% yoy) and 0.4% for public sector (1.5% yoy) wage and salary rates from the Labour Cost index (0.6% qoq overall). Wage inflation from the unadjusted LCI measure firmed to 0.9% qoq (3.4% yoy). There was also a strong rise in average hourly earnings on the QES measure – up 1.2% qoq (+2.2% yoy).

The impact of the July pay equity settlement for health care workers was evident in the figures, with the industry breakdowns showing large increases for community and personnel service workers (3.6% qoq, 5.0% yoy). **However, there was limited flow through to the wider labour market.** Median increases (2.2% for the quarter and year) remained relatively mild. Moreover, only 14% of jobs reported a quarterly increase in wage/salary rates. Distributional data confirmed that only 32% of salary and wage rates had achieved a wage increase above 2% over the last 12 months, with 18% achieving more than 3%. Around 20% of salary and wages showed annual increases of 2% or less, still well above 2008/09 levels.



Whilst the starting point is strong, a combination of demand and supply-side factors is expected to temper employment growth in the years ahead. Slowing growth momentum over the remainder of the year, uncertainty over the new government and concerns over signalled increases in the minimum wage may act to weigh on hiring decisions. Signalled changes to migration policy will likely slow labour force growth and shrink the pool of available workers at a time when firms are facing difficulties in finding the “right” person for the job.

Moreover, cost-push influences and government policy changes are expected to underpin wage growth going forward. We expect an additional 0.3 to 0.5 percentage points on 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. Increases in wages that are not matched by rising productivity could flow through into pressures on core inflation and a higher OCR. But, for now, an unsettled domestic outlook keeps the notion of OCR hikes firmly on the backburner.



Market reaction and policy implications

The labour market reports was the last significant domestic data release before the Reserve Bank's November Monetary Policy Statement (November 9). The NZD/USD spiked 50 points following the stronger than expected HLFS report, with the 2-year swap rate up 3 basis points.

At face value more pressures on labour market capacity will add to medium-term inflationary pressure at the margin. However, the low starting point for consumer price and wage inflation provides the RBNZ with valuable breathing space from which to observe forthcoming developments before having to move the OCR. 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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