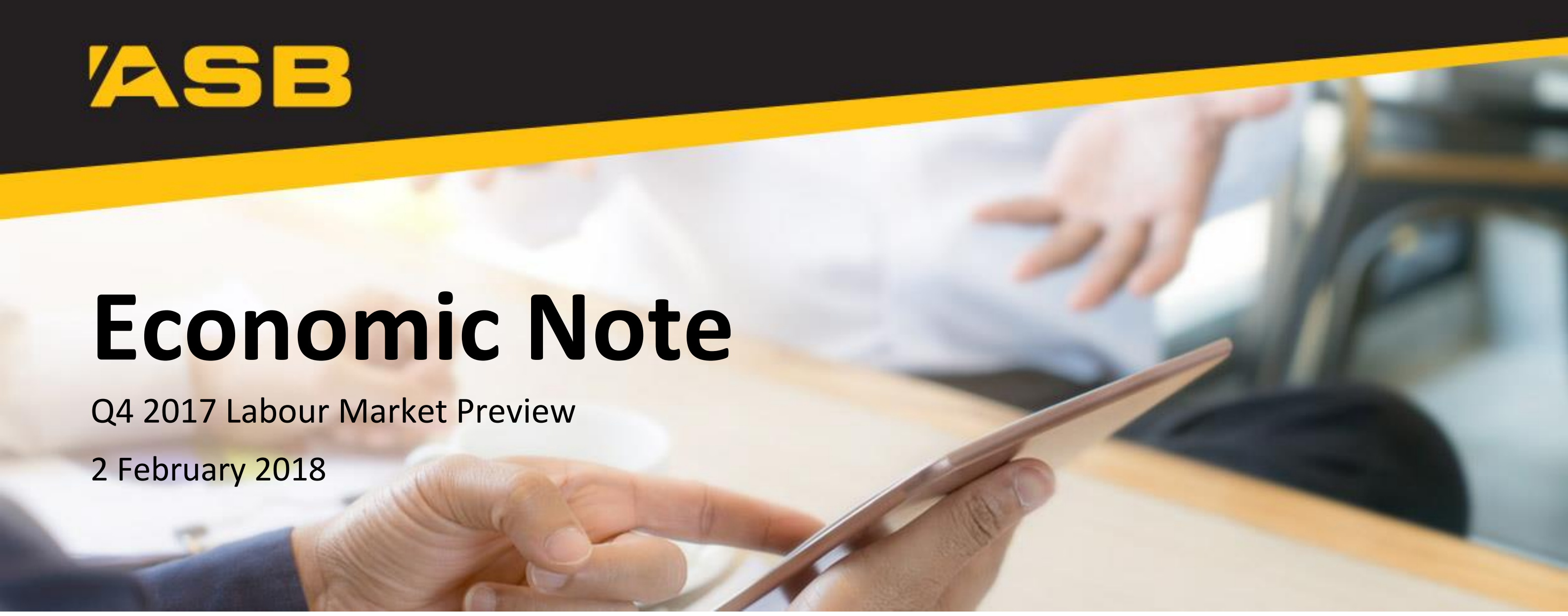

Economic Note

Q4 2017 Labour Market Preview

2 February 2018

Still tight

- We expect to see HLFS employment retrace some of its strong Q3 increase, with the Q4 unemployment rate expected to tick-up to 4.7% in Q4. The labour market is expected to remain tight, with elevated levels of labour utilisation.
- Quarterly labour costs are expected to climb just 0.4% qoq on the LCI measure, keeping private and public sector annual LCI inflation below the RBNZ inflation target midpoint.
- The tight labour market backdrop and pressures on capacity are likely to keep the bias tilted towards a higher OCR, but concerns over low inflation suggest a lower OCR should not be completely overlooked.

Q4 Labour Market Forecasts			
Indicator	ASB	Prior	Market
Employment growth (QoQ)	-0.3	2.2	0.3
Unemployment Rate (%)	4.7	4.6	4.7
Participation Rate (%)	70.6	71.1	71
Labour Cost Index			
Private Sector (%, QoQ)	0.4	0.7	0.5
Private Sector (%, ann)	1.9	1.9	2.0

Summary & implications

We expect a 0.3% qoq fall in Q4 employment from the Household Labour Force Survey (HLFS). We would view such an outcome as statistical recoil in light of the 2.2% qoq Q3 increase, rather than signalling a sharp slowdown in the demand for labour. A small fall is also expected for the labour force participation rate, which should cap the unemployment rate at 4.7%, its second-lowest level since 2008. Other metrics should depict a still-tight labour market, with elevated levels of labour utilisation.

Following the pay-equity settlement and minimum-wage generated lift in Q3, we expect a return to moderate quarterly increases for wages, with the private sector Labour Cost Index (LCI) wages up just 0.4% qoq (+1.9% yoy). Further pay-equity and minimum-wage increases, along with tight labour market capacity, are expected to gradually lift overall LCI wage inflation over the next few years.

Given the low inflation starting point and considerable uncertainties over the outlook for inflation, the RBNZ is expected to sit tight for a while yet. Over time, the tight labour market backdrop and pressures on capacity should help lift domestically-generated inflation and push the OCR higher. However, there is still the risk that wages fail to firm, which along with a backdrop of low headline CPI inflation and inflation expectations mean that the risks of a lower OCR should not be overlooked.

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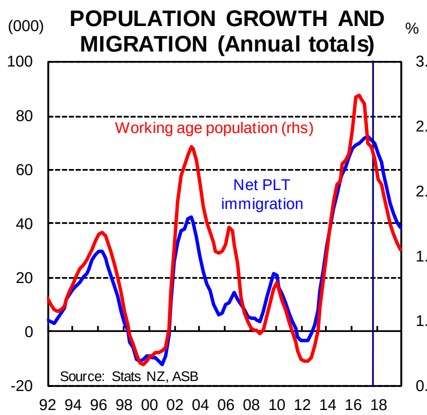
We expect overall HLFS employment to post a 0.3% qoq decline in Q4. Whilst surveyed employment intentions did dip in Q4, the primary catalyst is statistical payback in the context of the 2.2% Q3 surge in employment. The HLFS survey was redeveloped in 2016, but it has not eliminated the quarterly volatility that has characterised the survey. **Taking a quarterly average over the last four quarters yields an average quarterly increase of around 0.7%, resulting in a solid 3% annual increase in employment, with a net addition of around 75,000 jobs to the New Zealand labour market over 2017**. Other published **employment measures,** most notably filled jobs from the Quarterly Employment Survey (QES) **should deliver a positive quarter in Q4**, as should paid hours from the QES, an input into GDP.

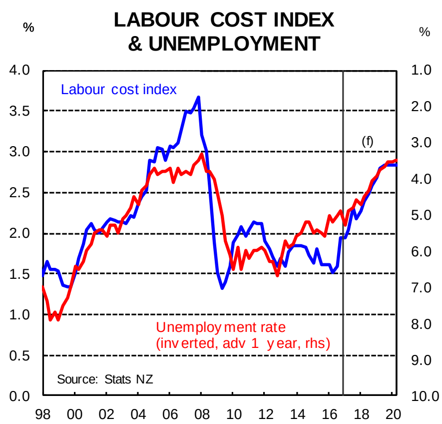
This quarterly volatility is also impacting other aspects of the HLFS, including surveyed participation and the unemployment rate. We expect a small fall in the surveyed participation rate (to 70.6% in Q4) from record highs. We also expect some pullback in the HLFS employment rate from its Q3 peak of 67.8% of the working-age population and some modest retracement of the labour force underutilisation rate (a measure of slack within the existing employment market). The closely synchronised movements for employment and labour force participation are expected to continue, which should moderate the climb in the unemployment rate. **The Q4 unemployment rate is expected to nudge fractionally higher, but at just 4.7% will be 2nd lowest reading since 2008.**

Growing labour supply (from record high levels of net migration) had 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 0.6% in Q4, with the annual growth at a still elevated 2.3%, an addition of 85,300 persons over the 2017 year. We expect the growth in the working-age population to slow by around 0.5 percentage points per annum over the next few years as net immigration retreats from record highs. 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. With a **solid outlook for employment, we expect that capacity pressures within the existing labour market will intensify, with the unemployment rate moving under 4% before the end of the year.**



Despite the tight labour market, we expect wage inflation to remain low for this stage of the cycle. Following the pay-equity settlement and minimum-wage related boost to wages in Q3, we expect normal wage trends to reassert themselves, with just a 0.4% qoq increase expected for both private (1.9% yoy) and public sector (1.4% yoy) LCI wages in Q4. Beyond the healthcare sector and those on the minimum wage (an estimated 3% of the workforce according to StatsNZ estimates), there is currently little evidence of a broadening front developing for wage increases.

We expect that, eventually, pressures on labour market capacity and these government policy changes will underpin wage growth going forward. Risks around our estimates are on the downside, particularly if the low headline CPI outlook (we expect annual CPI inflation to remain in a 1 to 1½% range over the next 12-18 months), has a greater influence on inflation expectations and wage setting behaviour than what we expect.



One of the puzzles of late has been why wage inflation has remained so low. 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 (i.e. record levels of net migration and labour market participation) look to have played a key role in tempering wage increases. Whilst economy-wide productivity has been woeful, we expect annual wage inflation from the unadjusted LCI measure (which includes compensation for productivity gains) of wage increases to remain close to 3.5% yoy. The resultant increase in real wages of approximately 2% over the year will provide some impetus to household spending.

Market reaction and policy implications

The labour market report is published on Wednesday, February 7, the day before the Reserve Bank's (RBNZ) February Monetary Policy Statement (MPS). In the November MPS, the Bank admitted it was uncertain on the trajectory for wages and highlighted that the relationship between labour market slack and wage inflation wage inflation may have changed since the Global Financial Crisis (see Box C, on page 18 of the MPS). Nevertheless, the RBNZ's outlook was for a firming in domestically-generated inflation, consistent with increasing pressures on the goods sector and labour market capacity. In November, the RBNZ only incorporated the direct impacts of recent policy changes into its forecasts for wage inflation in the November MPS (which were adjudged to add just 0.2 percentage points to annual wage inflation through till 2021 versus our estimates of a 0.3-0.5% annual impact). The RBNZ's conservative assumption may reflect the current uncertainties around wage-setting behaviour and an attempt to balance the downside risks to wage growth stemming from low inflation expectations.

Indeed, we see some risk that wage inflation fails to surface as quickly as the RBNZ expects, which would temper further rises in domestically-generated inflation. This should ensure that the OCR sabbatical remains a protracted one. The odds of a lower OCR should not be dismissed – but appear a long shot at this point in time.

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