RESEARCH

ECONOMY WATCH

1 November 2017

Labour Market Tightens Further

- **Unemployment rate drops to nine year low**
- **It will fall further**
- **Wage pressures rise**
- **Markets respond to heightened inflationary risk**
- **Corporates face margin compression**

Q3 New Zealand employment data was simply too strong to believe. The reported 2.2% surge in employment for the quarter was the strongest increase in the history of the series, with the exception of last June's aberration when Statistics New Zealand changed the way it measured employment. Yet this followed a reported 0.1% fall in the previous quarter. Moreover, data from the Quarterly Employment Survey (QES) shows full time equivalent workers (FTEs) increased just 0.8%.

We think seasonal adjustment issues, caused by past methodological changes, may be to blame for the volatility in the data. Whatever the case, treat the quarterly data with a pinch of salt.

BUT . . . the over-riding conclusion that can be reached from today's data is that the labour market is tightening by the second and is putting upward pressure on wages. Moreover, the tightening is in excess of RBNZ expectations and set to tighten even further.

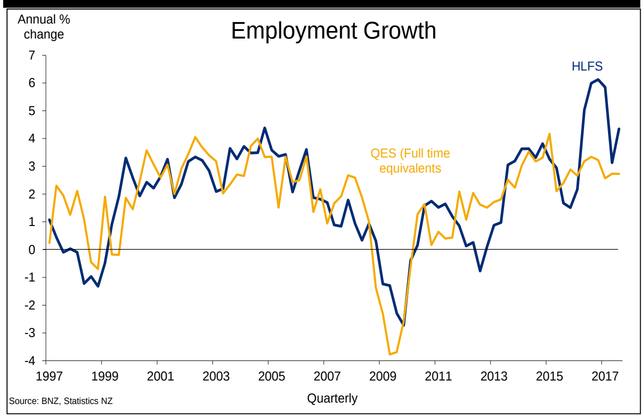
In particular, the fall in the unemployment rate to 4.6% looks "real". It's the lowest unemployment rate since December 2008 and should fall more. There is, naturally, some debate as to where New Zealand's NAIRU is. Whatever your view, it looks almost certain that we are either there or rapidly approaching it. Moreover, the RBNZ has forecast a trough in the unemployment rate of 4.5%. With net migration now in retreat, employment growth will need to slow rapidly to prevent the unemployment rate dropping below this level.

Rather than look at quarterly employment growth, we'd prefer to look at the trend over the last twelve months. On this basis, employment is expanding at around 1.0% a quarter. This is still stronger than the 0.7% a quarter for FTE growth as per the QES but, either way, there is a bucket-load of jobs being created in this economy.

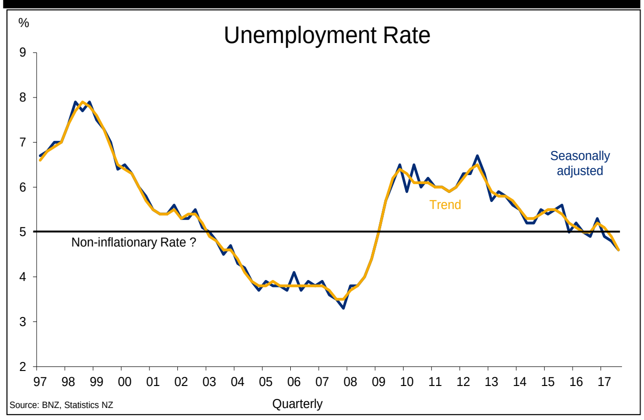
Importantly, New Zealand's participation rate is also going from strength to strength surging to a record high of 71.1%. Compare this with 65% in Australia and 63.1% in the United States. What it means is that there is very little spare capacity in the labour market in the event that demand remains lofty so skill shortages are likely to keep intensifying.

One of the big puzzles in many developed economies is the fact that GDP growth is above trend, unemployment rates are headed below NAIRU and yet there is minimal wage growth, and even less CPI inflation. New Zealand is no different in this regard. Our key private sector Labour Cost Inflation measure rose 0.7% in the quarter, the biggest increase since September 2008. But this was expected as 0.3 percentage points of this was attributed to the impact of a care and support workers pay equity settlement. The annual headline increase rose to 1.9% from 1.6% but all of this is attributed to that pay equity issue. More importantly, the increase does not look out of line with RBNZ expectations.

Strong employment growth



Unemployment slumps



National Australia Bank

If wage growth remains contained at these levels then, theoretically, an inflation-focused central bank would have minimal concern about the tightening in the labour market.

The big risk, here, though, is that wage growth now accelerates more than we all have assumed. With the minimum wage set to rise 26% over the next few years, against a backdrop of the tightening labour market, the chances of a trickle-up effect compounding the minimum wage effect are significant. Whether or not this feeds into CPI inflation is a moot point but the risks are clear. Either business will have to absorb rising labour cost pressures (meaning lower profitability) or they will require compensating volume growth (unlikely) or some pass through into selling prices. We reckon you will see some trade-off between profits and selling prices.

These developments support our view that the RBNZ will, eventually, be forced into bringing forward its proposed tightening cycle. Moreover, the strength in the labour market must call into question the views of those who believe that incorporating labour market conditions into the Reserve Bank's mandate will result in lower interest rates. We have more confidence in our forecast that the labour market will tighten than we do that CPI inflation will rise. On this basis, the inclusion of a labour market clause could, conceivably, imply tighter monetary conditions than would otherwise be the case.

Not surprisingly, the NZD pushed higher on the back of today's data with the currency up around half a cent against the USD. Short-dated interest rates also rose two basis points. We think this trend will be furthered when the RBNZ releases its November 9 Monetary Policy Statement which is unlikely to have the dovish tinge that many are now looking for.

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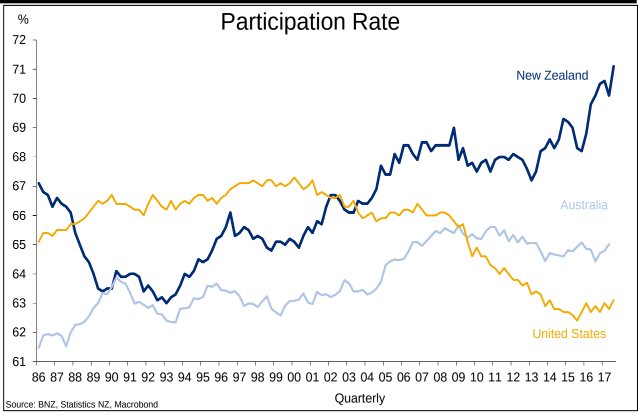
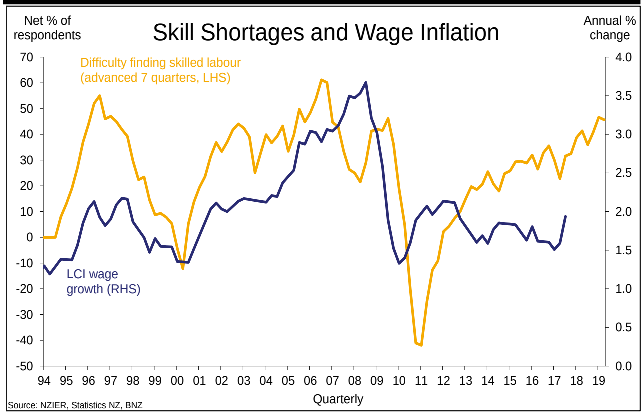
Soaring participation



Wages still contained



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