3 November 2021

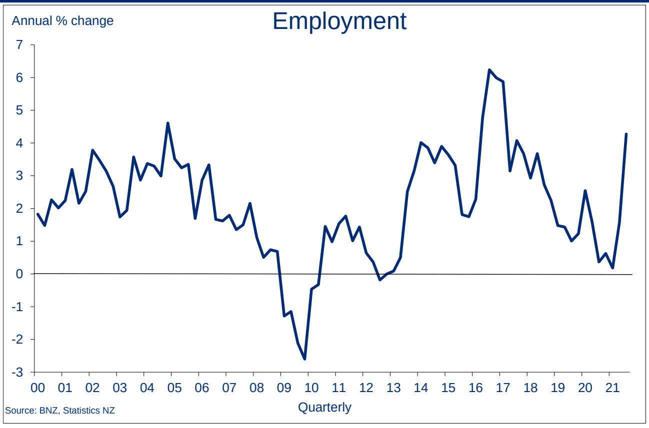
Maximum unsustainable employment

- **Employment soars in shutdown economy**
- **Unemployment rate plummets**
- **Wage growth pushes above "acceptable" levels**
- **Reinforces need to get cash to neutral relatively quickly**
- **Financial stability concerns provide a counter-balance**

There was a very high chance the Q3 labour market data, released today, would be outlandish. And so it proved to be. But no-one expected the data to verge on the ridiculous in the manner they did. This is not to question the validity of the data but to express concern that what we are witnessing may not be sustainable.

What has bamboozled us the most is that employment rose 2.0% in the quarter despite over a third of the country being in lockdown for half of the survey period. Importantly, the increase in employment was driven by full timers (+2.3%) compared with a 0.3% drop in part time. Household Labour Force Survey data dates back to March 1986. There is only one quarter (June 2016) when the quarterly increase was higher. Annual employment growth is reported at 4.2%.

Employment Soars



Source: BNZ, Statistics NZ

There are a number of reasons why the data should be very strong:

- Businesses are terrified of laying off staff as they fear they will not be able to re-employ them once COVID restrictions are lifted.
- The demand for labour in the sectors that are doing well is able to absorb labour losses in the distressed sectors.
- The wage subsidy is keeping folk in paid employment.

HLFS/LCI - Q3 2021	Actual	Mkt Expected	RBNZ Aug MPS	Previous
Employment - qtly % ch	**+2.0**	+0.4	+0.3	**+1.0**
Employment - ann % ch	**+4.2**	+2.7	+2.6	**+1.6R**
Participation rate %	**71.2**	70.5	70.5	**70.5**
Unemployment rate %	**3.4**	3.9	3.9	**4.0**
LCI, private ordinary - qtly % ch	**+0.7**	+0.8	+0.6	**+0.9**

HLFS data seasonally adjusted

- The government is taking on a significant number of staff. One assumes that a good number of these are to deal with the current COVID outbreak (contact tracers for example) and to deliver the vaccination programme.
- Construction continues to fire on all cylinders.

Nonetheless, it is really hard to conceive overall employment being as sustainably strong as reported.

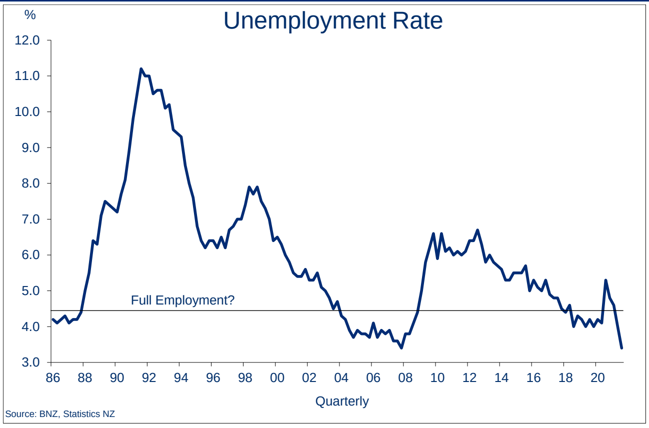
The June 2020 lockdown showed us you can get an aberrant drop in the unemployment rate due to a big fall in the participation rate. We thought there was a good chance this would be repeated. We got the slump in the unemployment rate, but the participation rate soared to 71.2% from 70.5%. This matches its record high reported in 2017.

Participation hits record

Source: Statistics NZ, BNZ

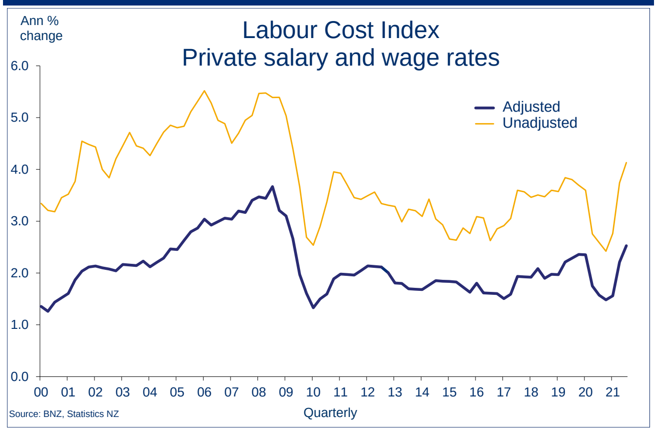
So the unemployment rate slumped to a 14-year low of just 3.4%. Compare this with the RBNZ's assumption that the NAIRU is around 4.5% and you can see it would take a major correction in the labour market to make the RBNZ comfortable that it was not well through its maximum sustainable employment target. The way things are going, the RBNZ will have to generate a recession to get the labour market back to where it wants/needs it.

Unemployment slumps



As expected, employment cost measures continued to inflate. The Labour Cost Index (LCI) rose by 0.7% to an annual 2.5%. This is well above the 2.0% considered consistent with the RBNZ meeting its inflation targets. Moreover, we now believe this measure will have pushed through 3.0% by early next year. To cap things off, the latest LCI showed that 18% of the surveyed workforce had pay increases in excess of 5.0% over the last twelve months.

Wages accelerate



Perhaps a better measure of true wage inflation is the unadjusted LCI whose annual rate of increase has now climbed to 4.1%. The quarterly employment survey also showed private sector average hourly earnings to be up an annual 4.2%. With annual CPI inflation pushing up towards 6.0%, and the labour market as tight as it is, pressure on wages can only intensify.

At face value, it would be easy to conclude that today's data give the green light to the RBNZ to raise its cash rate 50 basis points when it releases its next decision on November 24. But the RBNZ will be just as bamboozled as we are with regard to how it should interpret these results.

The big question is, how permanent (and/or real) are the headline figures:

- How long will the government keep its COVID workforce so high? For a few quarters yet, we suspect, as vaccinations roll on. And as COVID becomes endemic there will be more demand for contact tracers and health care workers.
- How many workers will lose their jobs when the wage subsidy expires? There are currently 1.27 million jobs covered by this subsidy. Note that this is jobs, not people. When the government moves onto its traffic light approach for controlling COVID the subsidies will disappear under Green and Amber. This will happen at the same time that the hospitality and retail sectors will be under most pressure. Inevitably jobs will be lost. But how many?
- Underlining the RBNZ's conundrum, Governor Orr, in his post Financial Stability Review press conference stated categorically that there is lots of volatility in labour market data. Read: be cautious in your interpretation of today's numbers. To the extent there is uncertainty, this would argue strongly for a 25 point move in rates not 50.

And it shouldn't be overlooked that total hours worked fell 6.6% in the September quarter. This is consistent with our view that GDP contracted around 7.0% over the period. In the September quarter many businesses would have been holding onto labour in the belief that the then lockdown would be short-lived. Their view of the world now could well be a lot different, especially as it looks like the economic bounce back in Q4 will only be of the order of 2.5% compared to the 7.0% we first anticipated.

Also released today was the Reserve Bank's latest Financial Stability Review. While this review is all about financial stability, rather than monetary policy, it is fair to say the document had a dovish feel about it. There were repeated mentions of the heightened uncertainty facing the economy. In particular there was much talk of the risks to growth from the extended COVID lockdowns and the move to living with COVID. Moreover, talk of asset price corrections was prevalent. On balance there appeared to be a nod toward slow and steady rather than the nuclear approach for the cash rate.

On balance, we are going to stick with our view the RBNZ keeps hiking 25 basis points at each of its next four meetings, with a target of at least 2.0% before the end of next year. However, we again acknowledge that the possibility of a 50 point move at the November meeting should not be ruled out.

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