RESEARCH

ECONOMY WATCH

1 August 2018

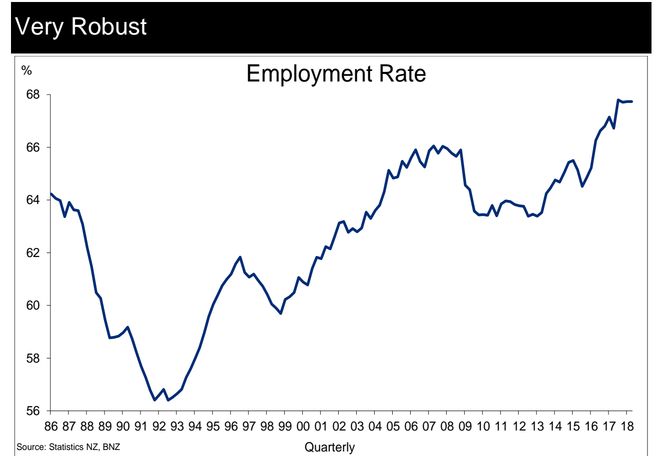
Labour Market Soldiers On

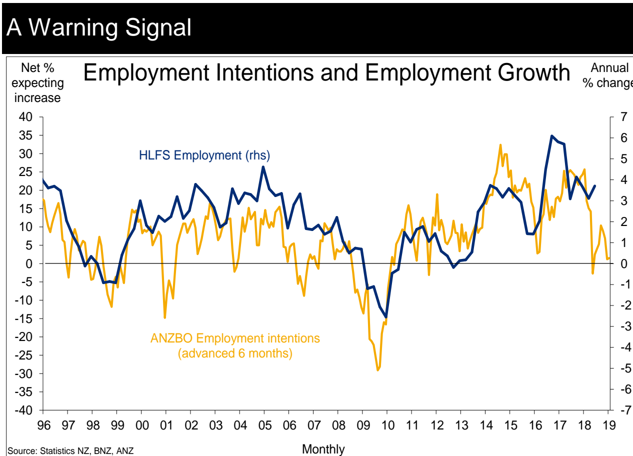
- **Labour market robust**
- **Supportive of a bounce in Q2 GDP**
- **Wages rise; minimum wage boost no one-off**
- **Employment expected to slow**
- **As labour supply tightens and unit labour costs rise**

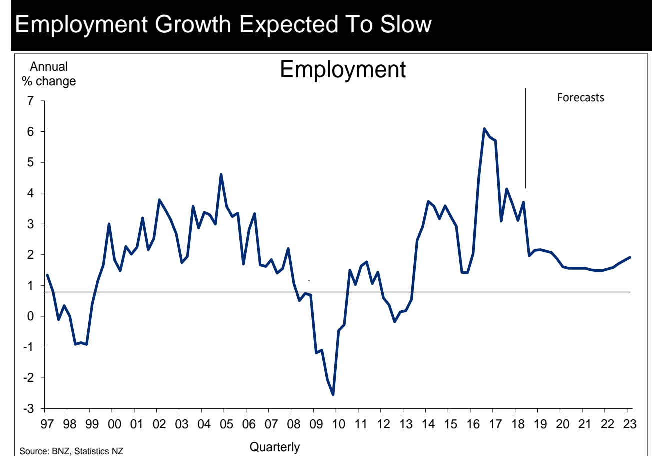
The New Zealand labour market remains robust. Employment is expanding, unemployment is low, and wages are rising. That's the main message from the suite of labour market reports published by Statistics New Zealand this morning. All the headline figures either matched, or were within 0.1, of expectations, so don't expect any material changes to economic assessments.

Some may focus on the marginal tick higher in the unemployment rate to 4.5% from 4.4% in Q1, as a sign of weakness and something of a slackening in labour market conditions. We wouldn't jump to that conclusion. Not with it being accompanied by a lift in the participation rate (to 70.9 from 70.8 – yes, international readers, it is that high) such that the employment rate remained steady at an elevated 67.7% of the working age population. The pool of potential additional labour remained broadly steady – we'd suggest the degree of tightness in the labour market has done the same. That fits with other labour market indicators from the likes of the Quarterly Survey of Business Opinion.

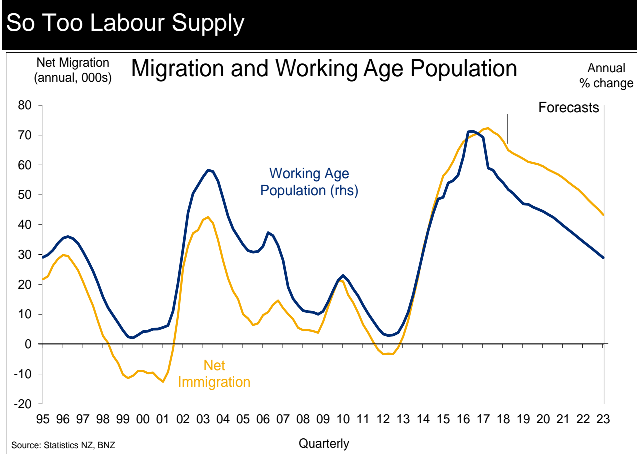
In any case, employment growth continues. And for all the hullabaloo about low business confidence and falling employment intentions, official Household Labour Force Survey (HLFS) employment has just expanded 3.6% over the past 12 months. That's 93,000 more people in work compared to a year ago – it's strong growth. That said, there are some signs that employment growth is slowing and we expect it to slow further as the supply of labour slows and the price of labour rises. The 0.5% quarterly seasonally adjusted increase in Q2 itself (actually a touch stronger than expected on the day) portends slower annual employment growth ahead. Beware the lags in the data. We think it would be unwise to dismiss the recent drop in firms' employment intentions and indicators from the likes of the PMI and PSI. We expect annual employment growth to slow to around 2% over the coming year, starting as soon as the next quarter. Incidentally, this continues to give us some unease around economic growth ahead.





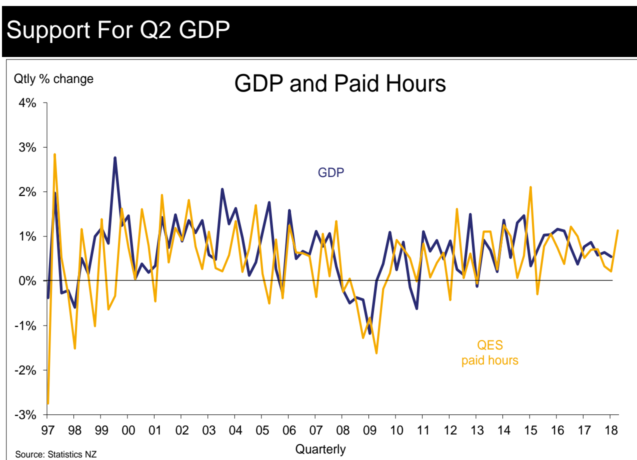


So Too Labour Supply



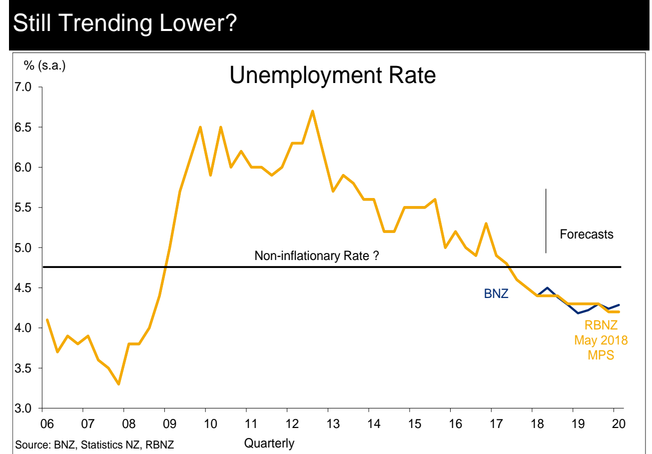
That is not to back away from our view that Q2 GDP will be stronger than Q1. Indeed, the details in today's labour market reports very much support that idea. For example, the Quarterly Employment Survey (QES) revealed filled jobs rose 0.8% in Q2 after a weak Q1, while paid hours posted a hefty 1.1% lift. In addition, actual hours in the HLFS rose 1.4% in the quarter. In fact, it all makes us wonder if our initial 0.8% pick for Q2 GDP might even be a bit on the light side. We'll stay there for now, but it does highlight the possibility of something stronger in that quarter while we worry about something softer thereafter.

Support For Q2 GDP



We cannot be sure how the raft of labour market statistics line up against the RBNZ expectations as the Bank, regarding these indicators, only provided forecasts for the unemployment rate on a quarterly basis in its latest Monetary Policy Statement. The 4.5% reading came in a tick higher than the RBNZ's 4.4% forecast. But in the context of a push higher in the participation rate and buoyant employment, filled jobs, and hours worked, we doubt the Bank will see the labour market's position much, if any, different today than it did when it put its forecasts together. Also, to us, wage inflation looks at least as strong as the Bank might have anticipated judging by the annual forecasts, but we cannot be sure given it does not publish a quarterly track.

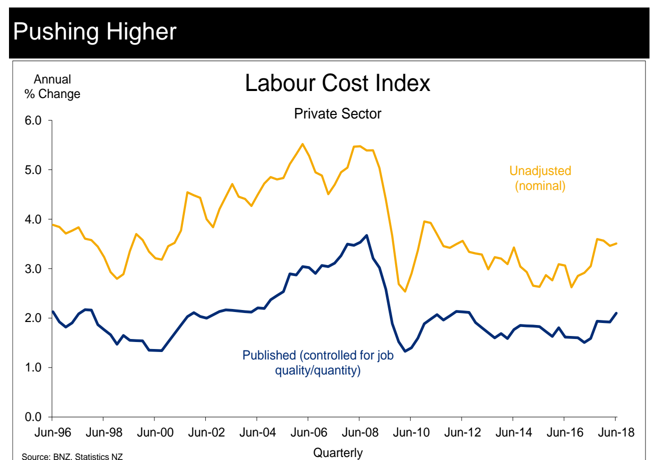
Still Trending Lower?



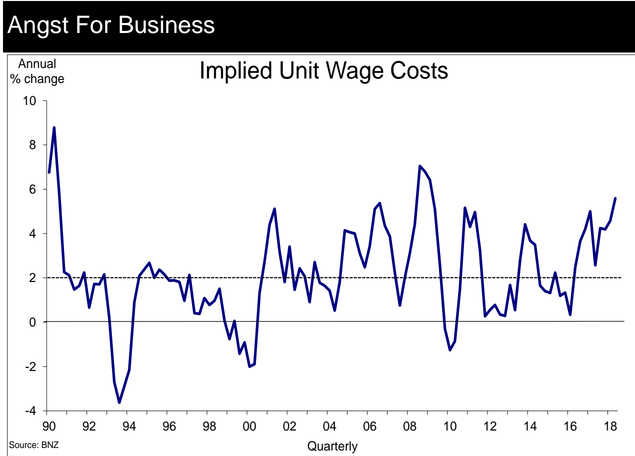
Wage inflation lifted in Q2, with the closely watched private sector LCI rising 0.6% in the quarter and 2.1% in the year – marginally above the level seen as being consistent with the midpoint of the RBNZ's CPI target. Sure, this included the influence of the 1 April, 4.8%, increase in the minimum wage. Excluding the minimum wage effect – by holding those affected wages constant – Statistics New Zealand noted the quarterly increase would have been 0.4% for annual inflation of 1.9%. Annual inflation also includes a previous care worker settlement. If you also exclude that, the annual gain in private sector LCI would have been 1.6%, the same as a year ago. All this suggests there is still little underlying wage inflation, although it is difficult to know what would have been the case absent the above changes. Simply holding wages constant to remove the effect has a feeling of a lower bound estimate for what would have happened absent the changes in question (wages don't typically decline), although we do wonder if this would really have changed the narrative.

But we suggest some caution needs to be used to simply treat the lift in the LCI as an aberration due to the minimum wage rise. It is no one-off. There are three more minimum wage increases penciled in over coming years

Pushing Higher



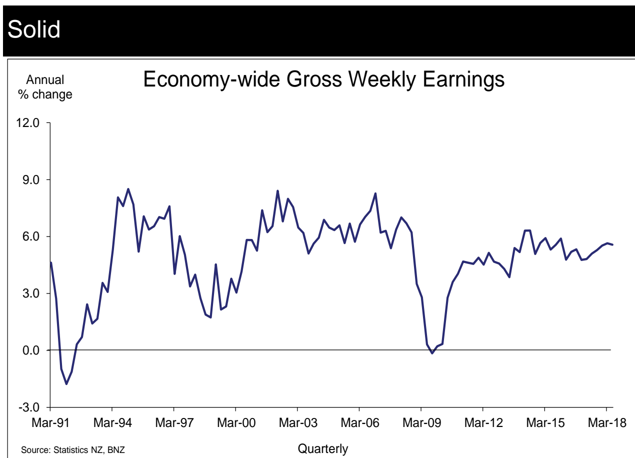
Angst For Business



and each of them is bigger than this year's event. There will likely be flow on effects to the wider market. Then there are growing public sector wage demands, future pay equity settlements, the generally increased pressure on wages from staff shortages and heightened demands for compensation for rising CPI inflation all of which is yet to be fully captured in the data. We expect annual wage inflation to generally edge higher over the coming two years.

Gross earnings – a measure of the overall wage bill – rose 1.4% in Q2 to be up 5.6% on a year ago, according to the QES. This represents strong income growth and should help maintain ongoing expansion in household spending. Average wages rose 0.2% in the quarter for 3.1% annual inflation. This is not the best measure of underlying wage inflation as it can be thrown around by compositional changes in the workforce. Meanwhile, the unadjusted private sector LCI rose 1.0% in Q2, to be up 3.5% on a year ago – this is our preferred measure of wage inflation and it has pushed up from 3.1% a year ago. In being above 1.5% CPI inflation over the year, it implies solid growth in real wages.

Solid



Higher wages are, of course, a good thing, but only when they are backed by productivity expansion. Wage inflation without productivity growth can simply lead to price inflation and or slower employment growth in which cases no real progress is made. That is the concerning trend we have seen over recent quarters. Rising wages, in themselves, are positive. But labour productivity growth has been poor with simple measures like GDP per full time equivalent employment even suggesting a decline over the past year. Before getting too downbeat, we should say that productivity is notoriously difficult to measure and revision-prone aggregate measures need to be treated with caution, especially over short time periods. But the general weakness in labour productivity over the past year has meant that wage inflation is driving unit labour costs higher.

This can be seen in the private sector LCI – a measure of unit labour costs – with annual annual inflation pushing up through 2%. Other measures, using average wage inflation and productivity estimates suggest unit labour cost inflation may be above 4%. Clearly precision is difficult, but both suggest that unit labour cost inflation is trending higher. Not aggressively so, but it is consistent with numerous measures of core inflation starting to edge higher.

Higher costs, including unit labour costs, are putting downward pressure on business margins – as was crystal clear in yesterday's business survey. It is making labour more expensive with firms' employment intentions cooling as a result. It fits with our forecast that annual employment growth will slow further. Annual employment growth has averaged around 3.6% over the past year. We anticipate growth of around 2% over the year ahead.

But it is not just the price of labour that is expected to cool employment expansion. There are also challenges on the supply side. Firms have long been reporting difficulty in finding suitable staff – whether skilled or unskilled. With net migration expected to continue easing back from its recent peak, working age population growth is forecast to ease below 2% next year having averaged around 2.4% over the past few years. Combined with an already very high participation rate, labour supply will struggle to maintain its recent pace, which will act to tighten the market for any given level of labour demand.

While firms may look to substitute capital for labour, more generalised cost pressures squeezing profitability sees investment intentions fading as well. All this is part of our growing unease around the growth outlook. The growth implications of concurrent slowing in both labour demand and supply are clear. Underlying economic growth will slow, all else equal. But the implications for inflation are ambiguous. It depends on whether labour demand or labour supply is easing most as well as the labour market's starting position. This latter point is important in the current context.

Numerous indicators suggest the labour market has been a touch on the tight side of neutral. Today's results suggest this remains the case with the unemployment rate below estimates of the rate that puts upward pressure on inflation. This means economic growth could slow a bit from here and yet inflation could continue to pick up. In time, growth may well need to slow in order to prevent overheating down the track absent a surge in productivity growth.

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