7 November 2018

Maximum Sustainable Employment Breached?

- **Labour market strength a big surprise**
- **Headline numbers might overstate the truth**
- **But no denying it's too tight for a rate cut**
- **As employment rate hits record high**
- **And wage inflation creeps higher**

HLFS/LCI - 2018 Q3

	Actual	Mkt Expected	Previous
Employment - qtly % ch	**+1.1**	+0.5	**+0.6R**
Employment - ann % ch	**+2.8**	+2.0	**+3.7**
Participation rate %	**71.1**	70.9	**70.9**
Unemployment rate %	**3.9**	4.4	**4.4R**
LCI, private ordinary - ann % ch	**+1.9**	+1.9	**+2.1**

HLFS data seasonally adjusted

We've been saying it for some time now. How can the RBNZ seriously contemplate cutting its cash rate (from its present record low) when the economy is in a position of maximum sustainable employment? That's the view we had when the unemployment rate was 4.4%. Following today's labour market data it now sits at 3.9%. More importantly, perhaps, the employment rate of 68.3% was the highest it's been since the HLFS survey was first reported in 1986. Surely, only if the unemployment rate is forecast to rise significantly from current levels can a rate cut be genuinely considered. We think it will edge higher but not to a level that would demand easier policy.

The RBNZ had assumed a 4.5% unemployment rate for the quarter based on an increase in employment of around 0.6%. As it turned out, employment actually rose 1.1% - miles higher than anyone had assumed. The unemployment rate would have plummeted further had it not been for an increase in the participation rate to a record high 71.1% – a level that would be the envy of most countries.

Key Employment Indicators

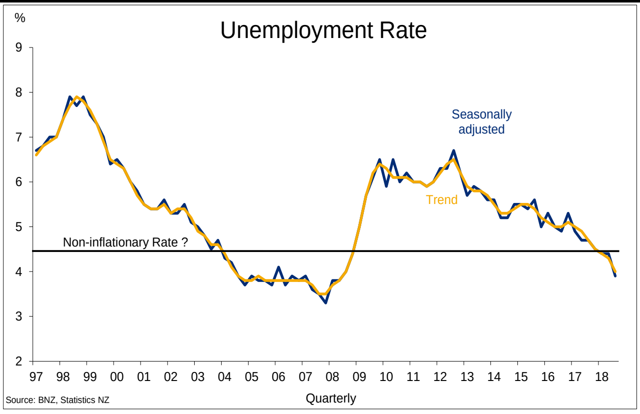
	% change	
	Qtr	Year
QES Filled Jobs	0.3	1.2
QES Paid Hours Worked	0.6	2.3
HLFS Hours Worked	0.0	2.2
HLFS Employment	**1.1**	**2.8**

The timing of this release couldn't have been worse for the folk at the RBNZ. They are required to report on the state of the labour market when putting their Monetary Policy Statement together. With that statement due tomorrow there really isn't enough time to build these data in to the extent that might be considered optimal. We suspect that, at the very least, there might be the odd word change in the front page of the document.

What we can say, categorically, however, is that since the last MPS: GDP growth has surprised the RBNZ to the upside; inflation (and, importantly, non tradables inflation) has surprised to the upside; and, now, the unexpected strength in the labour market has completed the trifecta.

Having said all this, we do caution that the labour market data should not be taken at face value. The HLFS employment data is by far and away the strongest of a suite of data describing the strength in employment. The accompanying table shows that Quarterly Employment Survey figures, and even the HLFS hours worked numbers, reveal a less robust market.

Unemployment Rate Sub NAIRU?



Employment Rate Record High

Moreover, the 30,000 increase in employment in the September quarter looks a bit rogue. Our view was that employment growth had fallen from around 25,000 a quarter last year to around 15,000 a quarter this year. If we are correct then it wouldn't be surprising to see near zero growth in the December quarter and a lift in the unemployment rate to back over 4.0%.

The RBNZ will be looking at the variation in these series too. Additionally, it will be interested in the fact that wage growth remains relatively constrained. According to the Labour Cost Index, the quarterly increase in the private sector ordinary time wage was a relatively muted 0.5% delivering an annual reading of 1.9%. This won't be far from the RBNZ's expectations and may well be used as evidence that even a tight labour market is failing to produce wage inflation. Be that as it may, it is the strongest September quarter increase in eight years, if you exclude last year's aged-care impacted result, and confirms that annual Labour Cost Index inflation is headed to 2.0%, which is the level seen as being consistent with the CPI being at a similar level. Moreover, we think that LCI growth will soon surpass the RBNZ's expectations.

Wage Costs Trending Higher

Not surprisingly, the market responded in a knee-jerk fashion to today's data. The NZD is up around 70 basis points and the last remnants of the chance of an easing have been priced out of fixed interest markets – at least for now. We have been arguing vehemently that the significant chance of an easing that had been priced in (as much as 50% prior to the Q2 GDP release) was inappropriate. The flat curve now makes more sense to us and no longer offers the same short-term trading opportunities.

We do not believe today's data will be sufficient to see the RBNZ move to a tightening bias any time soon. Indeed, we do not expect tomorrow's Monetary Policy Statement to look much different to the September OCR review. We also accept that the Household Labour Force data probably slightly overstate the true tightness in the labour market. Nonetheless, they are yet further evidence that this economy is operating at or above potential and that, as a result, there must be a very real risk that inflation rises to, and stays above, the mid-point of the RBNZ's target mid-point. Furthermore, RBNZ policy is about aiding ***sustainable*** growth and employment. Allowing things to get too tight risks the need for an aggressive policy response that could create unnecessary volatility in both output and employment. We don't expect the RBNZ to change its main message tomorrow but the odds of it being forced to a tightening bias by February next year are certainly rising.

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