ANZ Research

NZ Forecast Update: Rapidly approaching full employment

1 July 2021

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Contact

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Rapidly approaching full employment

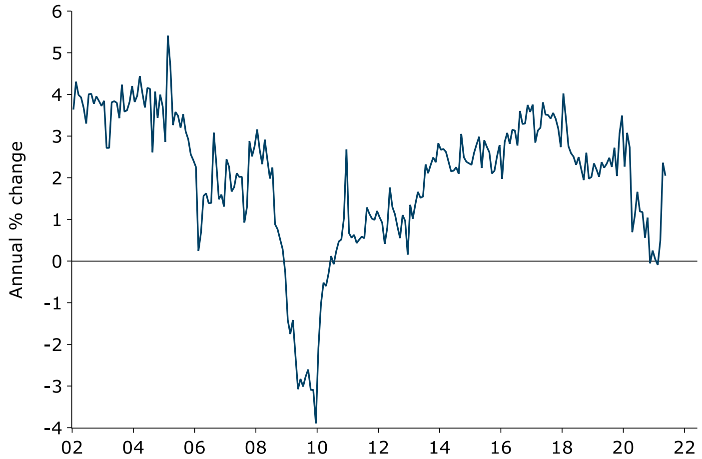
Bottom line

- We've upgraded our labour market forecasts, made in early May, to account for recent positive economic news, including the monstrous Q1 GDP print, robust monthly jobs numbers, record high job vacancies, and other survey and anecdotal evidence.
- We're now expecting a more rapid decline in the unemployment rate, falling from 4.7% in Q1 2021 to under 4% by 2023. That reflects a stronger outlook for employment growth, and a more advanced economic recovery in general. With the labour market tightening and inflation rising, we also expect to see a sizeable increase in wage inflation over this period.
- We're already seeing risks that OCR hikes might be needed even sooner than our February 2022 expectation, with CPI inflation forecast to hit 3% this year (with upside risk), and the labour market rapidly approaching full employment.
- The RBNZ continues to highlight their 'least regrets' strategy. They will want to see continued broad-based improvements across all their labour market indicators – crucially wage inflation and underutilisation. That's defensible, but there's a growing risk that the biggest regret could soon become waiting too long to hike.

The data have continued to beat expectations

Since we last updated our labour market forecast in May, we've had a raft of stronger data from a range of sources. Most notably, Q1 GDP massively surprised to the upside, with the economy expanding 1.6% q/q, versus our expectation of a 0.5% rise, and the RBNZ's forecast of a 0.6% contraction. We've seen other encouraging signs directly from the labour market too. Monthly employment data shows that the economy has continued to add jobs at a rapid pace (figure 1), despite our earlier expectation that matching issues and labour market dysfunction would make it hard for employers to fill vacancies. The number of jobs is now comfortably above pre-COVID levels, and is continuing to rise.

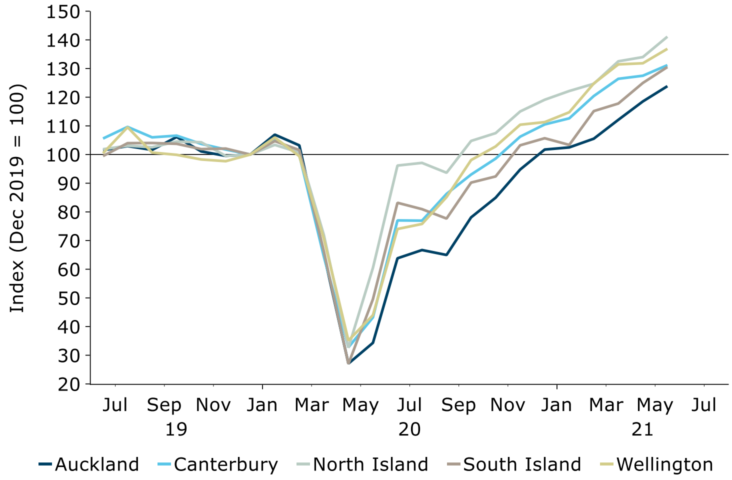
Figure 1. Monthly filled jobs



Source: Stats NZ, Macrobond, ANZ Research

And it looks like labour demand is only continuing to build. One indicator of this is job vacancies, which have risen way above pre-COVID levels across all the industries and regions tracked in the monthly data (figure 2). In fact, overall job vacancies have increased to well above previous record highs. While this may be somewhat 'artificial', insofar as it reflects the border closure (ie firms having to advertise in New Zealand, rather than overseas), the border closure is a real constraint on labour supply that doesn't appear likely to be resolved any time soon – the implied labour market tightness is very much real.

Figure 2. Job vacancies by region



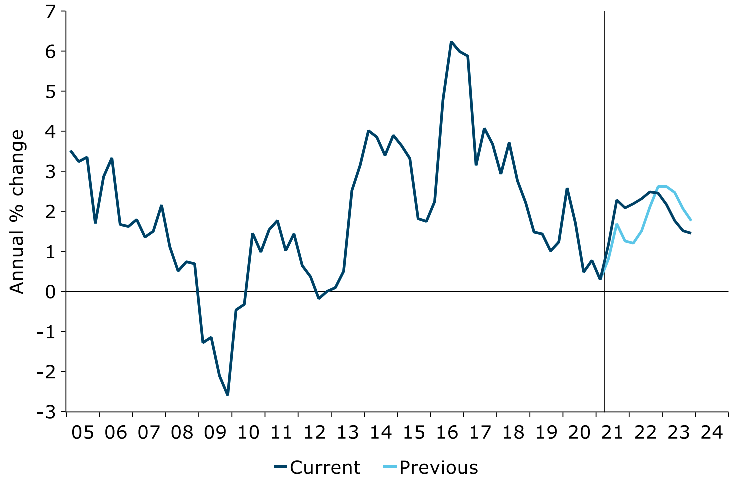
Source: MBIE, Macrobond, ANZ Research

Combine this data with robust employment intentions from the ANZ Business Outlook (especially in construction and services industries), as well as the almost constant news reports of businesses struggling to find workers, and even having to reduce their hours due to staffing shortages, and it's hard to see the labour market do anything but tighten further from here (assuming nothing unforecastable strikes from left field, of course).

Full employment is in sight

We've taken the strong data signal on board, and revised our labour market forecasts accordingly. Previously we expected that firms would struggle to fill vacancies due to various matching issues in the labour market (eg skills shortages or people simply being in the wrong regions compared to where the jobs are, given how distorted the economy is currently). However, this now looks to be less of an issue in terms of job creation – employers appear increasingly willing to take a punt on anyone they can get, and the rise in monthly filled jobs suggests employment growth will be higher than we previously thought. Accordingly, we've upgraded our near-term employment growth outlook, and brought forward the profile of employment growth over the next few years (figure 3). We do still expect employment growth to slow in the latter half of our forecast as OCR hikes start to take some of the momentum out of the economy, and a tight labour market makes finding workers increasingly difficult.

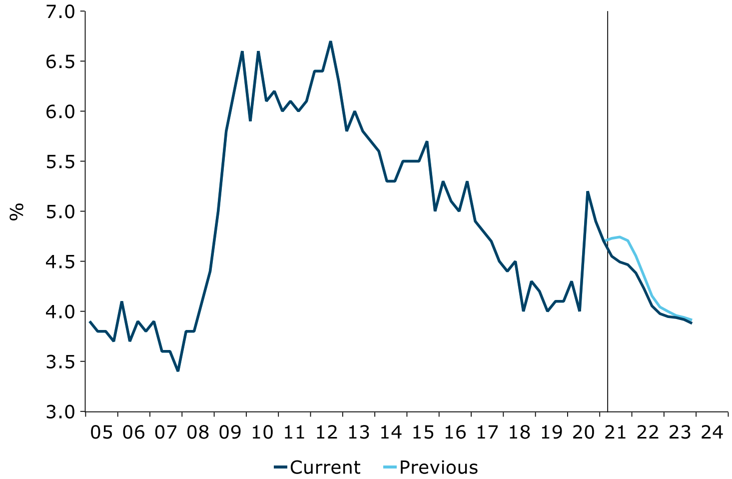
Figure 3. Employment outlook



Source: Stats NZ, Macrobond, ANZ Research

With the labour market managing to add more jobs than we previously thought, we expect that the unemployment rate will fall faster over the course of this year, reaching 4.5% in Q2, and dropping to below 4% by 2023 (figure 4). That brings the unemployment rate back to pre-COVID levels, and to a level that we would consider to be consistent with a labour market that's at full employment.

Figure 4. Unemployment rate outlook



Source: Stats NZ, Macrobond, ANZ Research

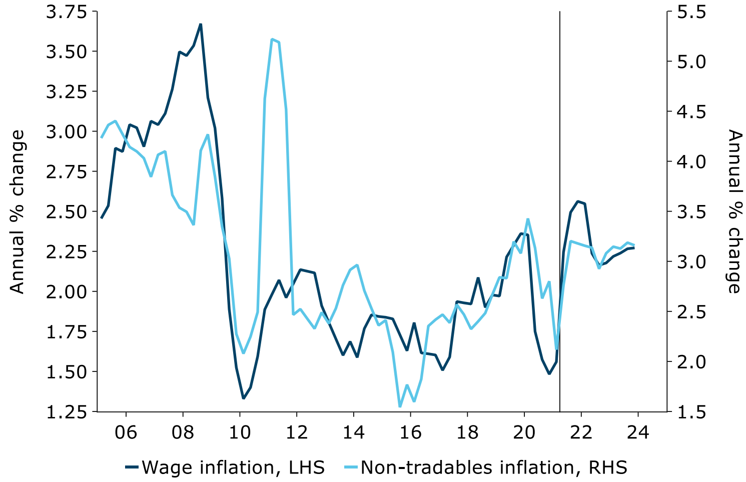
As always, the real wildcard is participation. We're expecting that the labour force participation rate will increase a bit in the coming year, reflecting continued recovery from COVID, better labour market conditions, and higher wages attracting people back into the labour force. But if participation doesn't increase, that could see jobs growth come in below expectations. But in that scenario, given its less labour supply rather than less labour demand, then all else equal, that would likely be even more inflationary.

Another risk is that the border reopening (we assume over 2022) could see labour supply lift at a faster pace than we expect. However, with demand looking very strong we think the likely impacts on wages and general labour market tightness would likely be relatively muted. Indeed, even when net migration was running around (or above) 50,000 per year over the late 2010s, we still saw unemployment grind its way down to 4%. And we think it's highly unlikely we'll see migration at these levels any time soon.

Overall, this view is consistent with recent modelling we've done, which found that net immigration didn't have a significant impact on wages growth or the unemployment rate (at an aggregate level at least).

With labour demand continuing to increase, labour supply heavily curtailed by the border closure, and domestic price pressures rising, we're expecting a sizeable increase in wage pressures over the coming year (figure 5). Further out, we're forecasting that wage inflation will settle just under 2.3% y/y in 2023 – consistent with our outlook for non-tradables inflation, and the labour market remaining tight. That's around what we saw towards the end of 2019, when the labour market last looked like it was at full employment.

Figure 5. Wage inflation and non-tradables inflation outlook



Source: Stats NZ, Macrobond, ANZ Research

So what's the hurdle for an even earlier OCR hike?

First of all, we should point out that this labour market outlook upgrade is not a precursor to an imminent OCR call change. Rather, the forecast upgrade is more about aligning our labour market outlook to the recent data (such as Q1 GDP) that led us to bring forward our expectations for OCR hikes a couple of weeks ago. That said, risks are building that an even earlier move might be needed, but we'll just have to see where the data lands over coming months.

In normal times, given our current set of labour market and inflation forecasts, we would probably be looking at OCR hikes sooner rather than later. After all, the RBNZ is a forecast-targeting central bank, ie they typically set interest rates based on where they expect inflation and employment to be in two years' time (ish), rather than where the economy is right now. And based on that criterion, hikes would be imminent, given we're a lot of hikes away from neutral.

But these are not normal times. Not only is the sustainability of our entire economic recovery contingent on reaching herd immunity from COVID (which likely won't be until the end of the year even if all goes to plan), but the economy is still incredibly distorted. Further, economic frameworks that central banks (and pretty much all forecasters for that matter) have relied on for decades have proven to be poor predictors of how the economy would respond to an unprecedented pandemic-induced recession. We think part of the explanation lies in an initial under-appreciation of just how significant the accompanying supply shock has been, something we outlined in more detail in our latest Quarterly Economic Outlook. The corollary of that is we've seen a lot more inflation pressure than was anticipated.

But the bottom line is, with monetary policy ammunition very low, data volatility still present (but gradually settling down), and the housing market (a key driver of economic momentum) still yet to settle following recent policy changes, the RBNZ will likely prefer to continue to wait for sustained strength in the data before concluding that conditions have been met to start lifting the OCR. Specifically, we'll probably need to see another significant drop (or two) in unemployment, as well as inflation well into the upper half of the target band (or even above) over 2021. And as the May MPS was at pains to highlight, it's not all about unemployment – the RBNZ considers full employment from a holistic lens, so they need to see broad-based strength in their suite of labour market indicators before considering the economy to be at full employment.

However, as we mentioned last week, the RBNZ's least regrets strategy is starting to look risky. The economy is running hot, the housing market is dangerously strong, household spending has surged, the labour market is well on its way to full employment, and inflation is at risk of rising above the target band, with inflation expectations now well above the midpoint – and rising. It may be tempting to wait and see what the data does in coming quarters, but the risks are tilting towards the biggest regret being not reducing stimulus soon enough, rather than monetary policy doing too little. A late start could mean more aggressive hikes are required, all else equal, which would increase the odds of a hard landing – particularly for the housing market. Though the future certainly remains murky, inaction comes with risks too, and it's increasingly looking like the RBNZ is getting caught between a rock and a hard place.

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Last updated: 9 April 2021

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