ANZ Research

NZ Labour Market Forecast Update: Applying pressure

3 February 2022

Contact

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Applying pressure

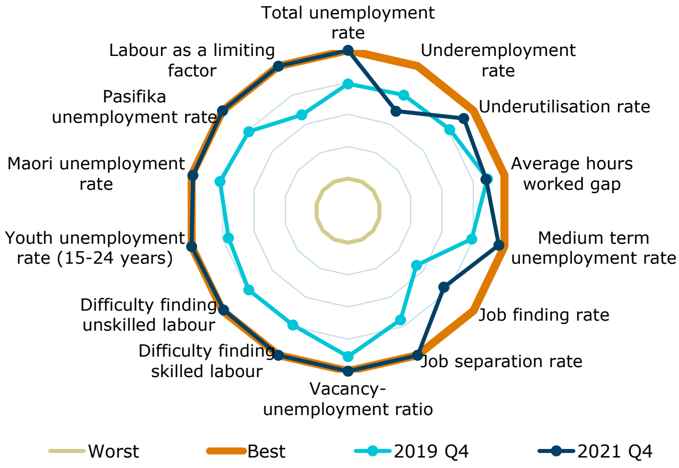
Introduction

- The labour market is the tightest it's been in the inflation-targeting era, with unemployment down to a record low of 3.2% in Q4, and many of the RBNZ's employment indicators as strong as they've been since at least the year 2000.
- We expect to see some further tightening in the labour market over early 2022, with still-constrained labour supply well short of meeting demand. We therefore see unemployment falling to a low of 2.9%, before gradually rising to 3% in 2023 as higher interest rates bite. Wage growth shouldn't be far behind – we're forecasting wage growth will accelerate from 2.8% y/y in 2021, to a peak of 3.8% in late 2022.
- Forecast uncertainty for the labour market is high (like everything at the moment). In particular, we don't know how the border opening will impact the labour market. While an open border makes it far easier to arrive, an unknown number of people will have been waiting for this development to leave – we're not the only country desperately looking for skilled workers. Omicron is another key uncertainty, as is the impact of tighter monetary policy.
- Given the uncertainty, we continue to expect the RBNZ will keep hiking interest rates in measured 25bp increments, to a peak of 3% in April 2023. But risks abound – the Kōtuku will be navigating some turbulent air as we move through 2022.

Where is the labour market now?

Q4's labour market print, while coming in a touch softer than our top-of-market expectation, was still very strong. The unemployment rate was 3.2% in Q4 – a record low in the HLFS data (which goes back to 1986), and that was in the context of a participation rate that at 71.1% is only a whisker below its record high of 71.2% in the previous quarter. Figure 1 shows how the RBNZ's indicators of the labour market are tracking – the vast bulk are now at or close to the orange line, ie the strongest outturn since 2000. This reflects the sheer strength we're seeing in the overall labour market picture.

Figure 1. RBNZ employment indicators



Source: Stats NZ, MBIE, NZIER, RBNZ, Macrobond, ANZ Research

Note: The yellow circle in the middle is the worst outcome since 2000, while the orange circle is the best outcome since 2000. The light blue line shows the state of play in 2019 Q4, when the RBNZ said "employment is at or slightly above its maximum sustainable level" in the February 2020 MPS. The details of the indicators are outlined in this RBNZ Analytical Note.

There were some relative soft spots, with average hours worked still down 4.1% y/y, having only partially re-traced their lockdown-induced fall in Q3, while underemployment also ticked up 0.2ppts to 3.4% of the labour force. But underemployment is still very low relative to the post-GFC period, and measures like hours worked are going to continue to be volatile as COVID outbreaks disrupt the labour market. This is a temporary dynamic, and as we've discussed previously, in the big picture COVID is more likely to reduce labour supply than dent demand – that's inflationary.

For the RBNZ, they're likely to look at figure 1 and come to the same conclusion as us – labour demand is well in excess of the amount available, and that's going to be a persistent driver of stronger wages (and therefore domestic inflation) over the next year or so. True, wage inflation wasn't quite as strong as they (or we) expected in Q4, and that saw the market dial back slightly the odds it's placing on the chance of a 50bp hike in February. But in a labour market this tight, wage inflation won't be far behind (something we discuss extensively below).

The outlook for unemployment

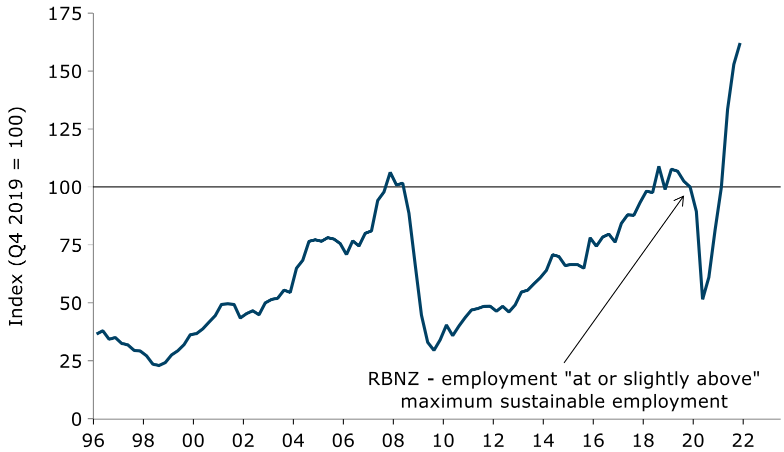
So, a record low of 3.2% unemployment – is that the limit? It seems unlikely, when we take a step back and look at what's actually driving labour supply and demand in the New Zealand economy.

On the supply side, the border is still closed (albeit not for long, touch wood), while participation is hovering around record levels. In the near term, then, it's going to be an uphill battle to bring more people into the labour force (especially with Omicron spreading in the community), and it will require firms to make their jobs ever more enticing (ie higher wages and/or better working conditions). Of course, with 3.4% of the labour force still underemployed, there's scope for some workers to increase their hours, but firms have copious amounts of vacancies, so even a further reduction in underemployment won't do much to ease things.

With the Government announcing plans for the imminent (albeit gradual) reopening of the border, that could open up international labour markets for Kiwi firms. But there'll also be a queue of Kiwis wanting to head overseas once they know they won't have to go through the MIQ lottery to return home, and there's plenty of demand for skilled workers overseas, including in our nearest neighbour. Indeed, tight labour markets have very much been a global phenomenon, so it's not clear that attracting international applicants will be easy for some industries. All up, it's highly uncertain how the border opening will actually impact the labour market. For now we've assumed a moderate boost in labour supply (and employment) from H2 2022 onwards, and we'll watch developments closely over this year.

But for now, the domestic labour supply is very constrained relative to what seems to be insatiable labour demand. We can see this in the ratio of the job-vacancy index to the implied number of unemployed people from the HLFS – it hit another record high in the December quarter (figure 2). Hiring intentions in both the QSBO and our own Business Outlook remain positive, implying it'll take even more slowing in labour demand before the intense pressure in the labour market eases. One factor dampening demand will be higher interest rates, as the RBNZ acts to bring surging domestic inflation pressures back to earth.

Figure 2. Job-vacancy to unemployment ratio

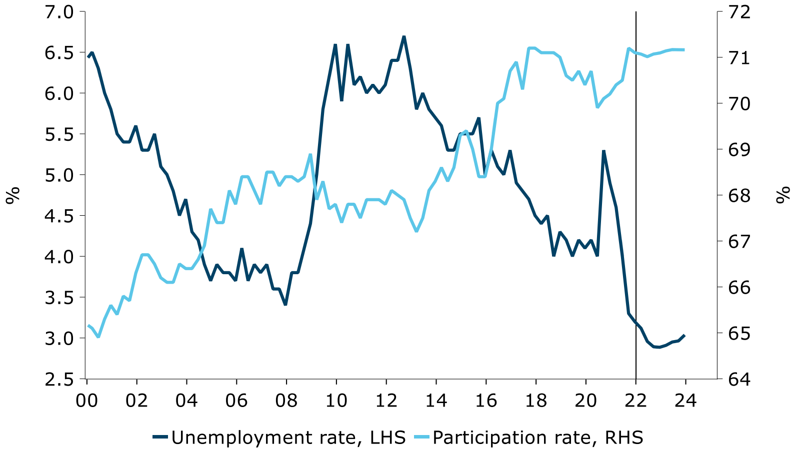


Source: Stats NZ, MBIE, Macrobond, ANZ Research

We expect the unemployment rate will fall a touch further to a low of 2.9% in Q3 2022, and hang around the 3% level until the end of 2023 (figure 3).

But if the past two years have taught us anything, it's that forecasting even one quarter ahead in the time of COVID is highly uncertain. It's possible that tighter monetary policy becomes a more significant drag on employment than we've factored in, seeing unemployment rise closer to 4%. However, there's so much excess demand in the labour market currently that under our central scenario of the RBNZ achieving a soft landing for the economy, we think the labour market can handle a fairly sizeable rise in interest rates before it would result in higher unemployment.

Figure 3. Unemployment and participation rate forecasts



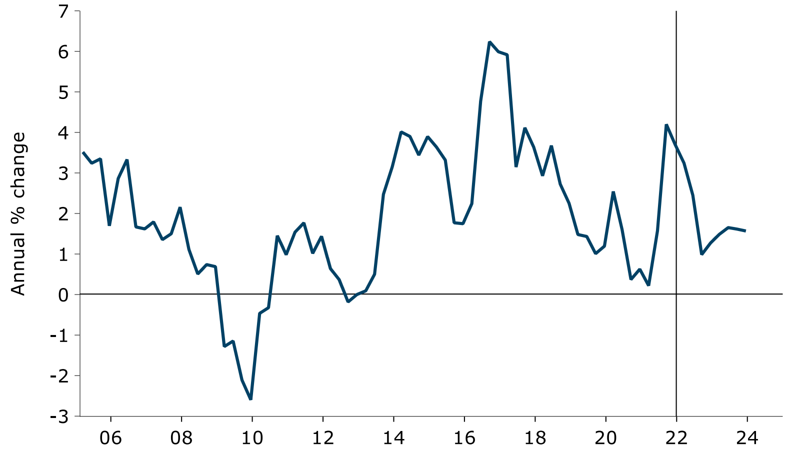
Source: Stats NZ, Macrobond, ANZ Research

We assume that the participation rate will hold up close to current levels (figure 3). Rising inflation is undermining real wages, so some household members may need to enter the labour force to make ends meet. At the same time, firms are desperate for workers, so as wage offers improve, more people will likely be lured into employment.

The real risk for participation is Omicron. If the overseas experience with widespread community spread is anything to go by, we could see a significant drop in participation, at least temporarily. That would only exacerbate the mismatch between labour demand and supply – and therefore boost inflation. So at this point, it's actually an upside risk to already too-strong domestic inflation.

Finally, touching on employment – in a labour market this supply constrained, the outlook for employment growth is not strong – not for lack of trying! We're expecting very slow employment growth over the first half of this year, with some improvement over the second half and into 2023 as the border opening is assumed to provide a net boost to employment levels in New Zealand (figure 4).

Figure 4. Employment forecast



Source: Stats NZ, Macrobond, ANZ Research

How low can you go?

When the labour market is this tight, forecasting the unemployment rate requires a guesstimate of the what the limits are.

There are a few things going on at present.

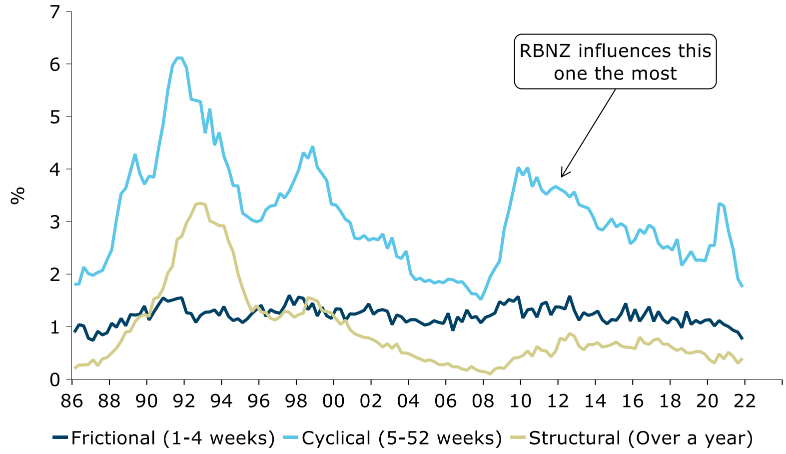
Firstly, COVID has changed the shape of the economy. And it's hard for people who lose jobs in one industry to transition into another industry – especially if such a shift requires physically moving regions or retraining. So there's still some sand in the gears of the process in of matching unemployed people with vacant positions (economists call this a decline in 'matching efficiency').

Secondly, the labour market is always characterised by some level of unemployment. "Frictional" unemployment captures people who become unemployed for a short period in between jobs. And long-term unemployment reflects structural issues that bar people from being able to find employment.

If we loosely define frictional unemployment as lasting a month or less, and structural unemployment as lasting for over a year, then together these two amount to about 1-2% of the labour force in the past two decades (figure 5).

Given monetary policy can only really affect the cyclical side of things, these factors mean we may struggle to see unemployment drop much further than the already record-low 3.2% in Q4 – hence our forecast for a 2.9% trough in the unemployment rate. That said, we've been pleasantly surprised by how much employment has been able to grow in recent months, so add it to the pile of uncertainties that could surprise us.

Figure 5. Frictional, structural, and cyclical unemployment1



Source: Stats NZ, Macrobond, ANZ Research

On a related note, it's worth touching briefly on why the RBNZ doesn't aim for zero unemployment. There are lots of good ways to reduce the average level of unemployment over time (skills training, investment in mental and physical health, a laser focus on marginal tax rates etc). But running monetary policy too loose for too long isn't one of them. It just results in boom-bust cycles, resulting in deeper recessions than necessary that hit the most vulnerable the hardest.

That's not to say that a period of heat in the labour market doesn't has its advantages! It provides a strong incentive for firms to invest in productivity-enhancing technology that will underpin higher real wages in the future, and

[1] This decomposition follows an equivalent analysis by the RBA.

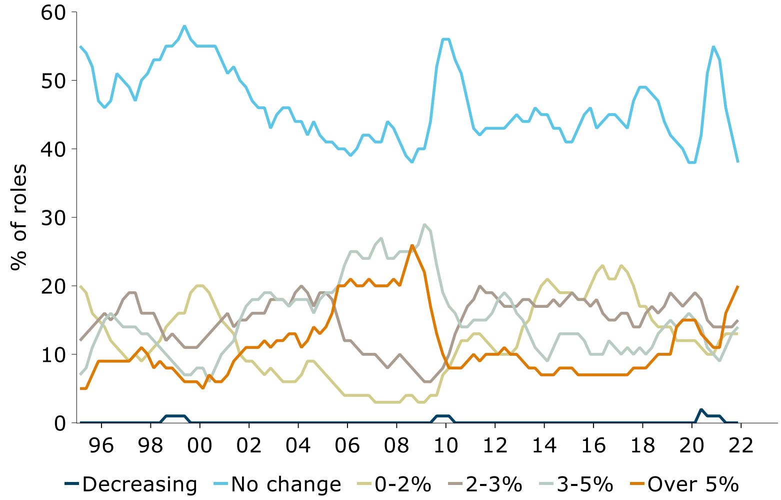
it provides individuals with opportunities to upskill that should set them in better stead for the rest of their careers. But monetary policy does not and should not deliberately attempt to keep unemployment lower than is sustainable. It just won't end well, unfortunately.

The outlook for wages

Probably the most disappointing aspect of the jobs report yesterday was the headline number for private sector wages, with the Labour Cost Index rising 0.7% q/q (2.8% y/y), versus widespread expectations for a 0.9% q/q lift. That suggests we're not yet seeing the kind of wage prints that would be consistent with a labour market this tight.

However, under the hood there were some encouraging signs. The unadjusted LCI was up a solid 1.1% q/q (4.2% y/y), while average hourly earnings came in at 1.4% q/q (4.1% y/y). Both were actually very good prints for Q4, when wage rises are usually a bit lower. And, the share of jobs receiving a 5% or larger annual pay rise for the year to December 2021 was up to 20% - the highest reading since 2009, and a marked lift from just 7% in the mid-2010s (figure 6). The share of roles receiving no pay rise is at an historic low of 38%.

Figure 6. Distribution of annual wage rises



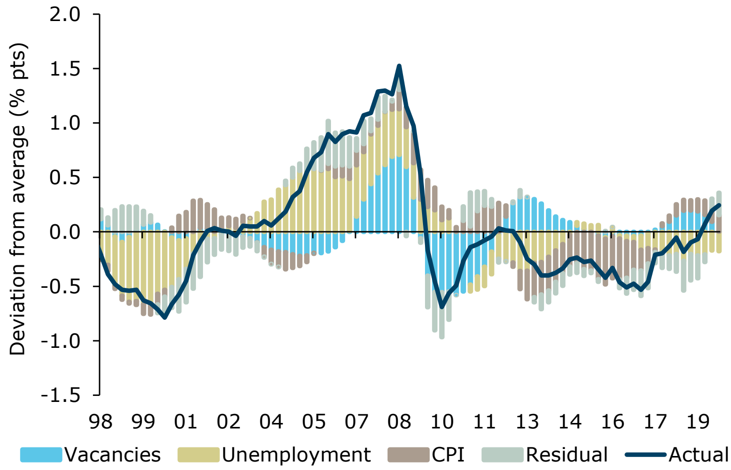
Source: Stats NZ, Macrobond, ANZ Research

But the fact remains that at 2.8% y/y, annual growth in the LCI is still well short of what we would expect to see, given an unemployment rate of 3.2% and CPI inflation of 5.9%. So why haven't we seen the kind of strong wage inflation that characterised the mid-2000s when the unemployment rate was last in the 3s?

It's probably because wages just take a while to adjust. We've gone through a decade where inflation was too low for the RBNZ's target, and where indexing once-a-year pay reviews to last year's inflation probably wasn't a bad strategy in terms of keeping up with the cost of living. This inertia in wage-setting behaviour may take some time to be overcome. But with low unemployment, high vacancies, and the surging cost of living, that adjustment will have to happen, or firms will find the resignation letters piling up.

Historically, we estimate that low unemployment and high vacancies over the mid-2000s were significant and persistent drivers of the above-average wage growth we saw over that period (figure 7). In the mid-2010s, on the other hand, below-target CPI inflation was an active drag on wages. Right now, all three factors are pointing strongly upwards. And while it may take some time for wage growth to rise to the levels we saw in the 2000s, we think it will. As figure 7 shows, high labour demand (vacancies), low labour supply (unemployment), and the rising cost of living (inflation) are very persistent drivers of high wages – so we expect a solid rise in wage growth over the next few years.

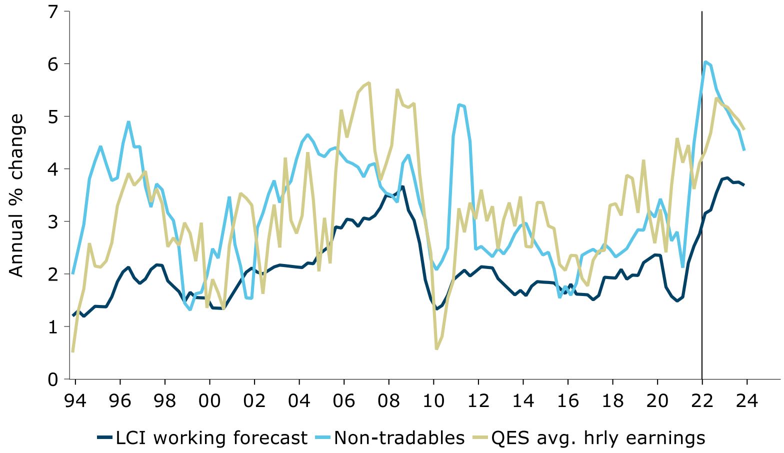
Figure 7. Historical drivers of NZ wage inflation (excluding COVID years)[2]



Source: Stats NZ, MBIE, ANZ Research

Turning to the numbers, we're anticipating that wage growth will accelerate over 2022, with LCI wage inflation rising from 2.8% in Q4 2021 to a peak of 3.8% at the end of the year. And average hourly earnings growth is forecast to lift to a peak of 5.4% in the second half of this year, from 4.1% currently (figure 8). Beyond that, tighter monetary policy should help to bring domestic inflation pressures back under control – and in turn that will reduce the pressure on wages from the cost of living.

Figure 8. Wage inflation forecast and non-tradables inflation



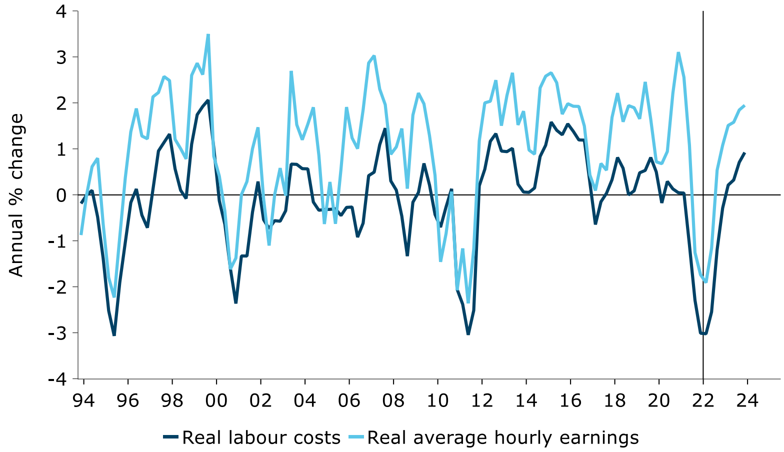
Source: Stats NZ, Macrobond, ANZ Research

Given the strength in CPI inflation in recent quarters, it's no surprise that real wages are falling rapidly at present. In the year to December 2021, inflation-adjusted average hourly earnings were actually down 1.7%. So even if on paper the labour market is the tightest on record, many households probably still feel like they're going backwards.

[2] Technical details: The figure shows the historical decomposition of de-meaned wage growth after estimating an SVAR from 1995 to 2019 (ending in 2019 to avoid COVID-era volatility). We use the svars package in R.

There is reason for cautious optimism on that front. Our forecasts for wages and inflation imply real wage growth back in positive territory towards end-2022/early-2023, before accelerating over the rest of 2023. However, until then, households may have to wear the cost of declining real wage growth – and that will reduce demand, and probably contribute to soggy consumer confidence as well.

Figure 9. Real wage growth implied by our forecasts



Source: Stats NZ, Macrobond, ANZ Research

Bringing it all together

Overall, this labour market is highly inflationary. A 3.2% unemployment rate is a good thing, absolutely. But inflation is gobbling up the gains that households might expect to see in a labour market this favourable for workers. And for the RBNZ, it's quite clear that the mismatch between labour demand and supply is not consistent with low and stable inflation. In fact, the super-tight labour market will likely be a strong contributor to domestic inflation pressures over 2022.

In order to bring demand back in line with supply, we see the RBNZ lifting the OCR in 25bp steps to 3% in April 2023. That's assuming nothing goes wrong though, and that the RBNZ is able to engineer a soft landing. The history of inflation targeting suggests that's easier said than done from this core inflation starting point. That's consistent with our earlier discussion of boom-bust risks caused by monetary policy being too stimulatory for too long – which, with the benefit of hindsight, it has been.

The good news is that as long as the wheels don't fall off, we're not forecasting that higher interest rates will cause a significant rise in unemployment – demand is so out of whack with supply that the RBNZ can probably hike interest rates pretty far before causing many job losses. But there's always the risk that higher interest rates prove more potent – particularly after the bonkers increase in house prices that we've seen in the past year and a bit.

And while we normally focus on the demand side of the equation when forecasting, labour supply is equally important at the moment. Border impacts are just one more uncertainty to add to the list.

All up, this uncertainty speaks to the RBNZ continuing in measured 25bp steps as they gradually tighten monetary policy.

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