ANZ Research

NZ Insight: Labour market capacity indicators

29 November 2023

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Labour market capacity indicators

- Our suite of labour market capacity indicators suggests that the labour market is no longer in an inflationary state, despite the unemployment rate still sitting below our estimate of the non-accelerating inflation rate of unemployment (NAIRU).
- While transitioning the labour market back to maximum sustainable employment is an important milestone for the RBNZ in its inflation fight, ultimately a sustained period of slack in the labour market is required to generate the necessary downward pressure on domestic inflation. In other words, the cold hard reality is that further softening in the labour market will be the cost of achieving lower and stable CPI inflation over the medium term, and the loosening we're now seeing in the capacity suite data is part of the RBNZ's plan.
- We will continue to monitor the suite of labour market indicators closely to assess whether monetary conditions are appropriate.

On track

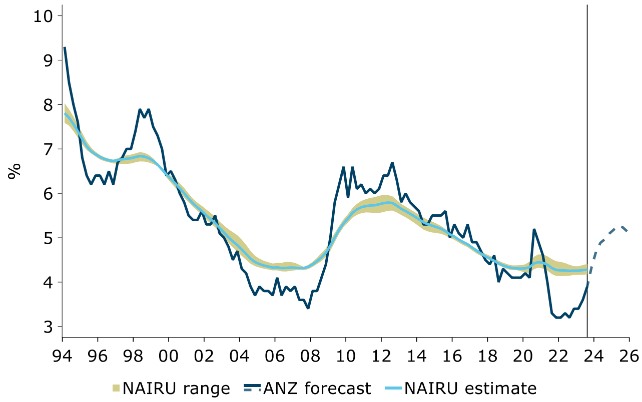
The labour market is a key driver of domestic inflation, and up until recently it has been in an unprecedented state of tightness. That has now changed, with the labour market having loosened considerably over the past year. The ongoing labour supply lift due to the record surge in net migration has been a key driver, although there is also evidence that monetary policy is gaining traction in reducing labour demand.

While the unemployment rate remains relatively low at 3.9%, and below our estimate of the non-accelerating inflation rate of unemployment (NAIRU), it is only one indicator of capacity pressure in the labour market. And because it tends to be a lagging indicator (ie one of the last labour market indicators to respond to changes in the business cycle), policy makers are aware that any assessment of labour market slack based on the unemployment rate alone is analogous to driving a car while looking only in the rear-view mirror. To provide a timelier estimate of labour market conditions, it is necessary to draw on a wider range of indicators.

In this note, we provide an update on labour market capacity pressures, which we think suggest the labour market is no longer in an inflationary state (as incorporated into our latest forecast). Indeed, the Q3 labour market release suggested the imbalance between supply and demand in the labour market is resolving a little faster than previously anticipated. That, combined with a downgrade to our near-term CPI forecast, and the softening across many capacity indicators (including those outlined in this note), has led us to confine our previous expectation for another OCR hike this cycle to the 'risks' basket.

But importantly, the recent run of data marks only the first milestone towards what's required. The trend in the indicators presented in this note (alongside a broad swathe of other data and developments) needs to continue for a time before the RBNZ will consider sticky domestic CPI inflation risks appropriately contained and cuts can be considered. That's the case whether maximum sustainable employment is an explicit monetary policy objective or not.

Figure 1. Unemployment rate vs NAIRU[1]



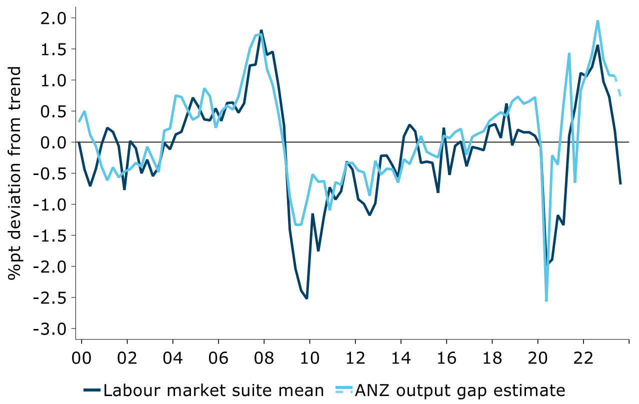
Source: Stats NZ, Macrobond, ANZ Research

Labour market pressures have faded

We estimate labour market capacity pressures using the 14 indicators that the RBNZ uses to monitor maximum sustainable employment (MSE), covering unemployment, underemployment, underutilisation, employment, surveyed measures of labour market capacity pressures, average hours worked, job vacancies, and job finding and job separation rates (see pages 5 and 6 for these indicators). To estimate capacity pressures, we estimate the deviation relative to each indicator's long-run trend or equilibrium level and scale these indicators to our output gap estimate.

Our output gap estimate is calibrated to our estimate of the unemployment rate gap (the difference between the unemployment rate and NAIRU), and the deviation of GDP from an underlying trend using filtering methods. We also draw on various business survey measures of capacity stretch to inform our judgements. Hence, the maximum sustainable employment suite provides a further indication of capacity pressures in the labour market, and indeed the economy more broadly, by including indicators that typically lead the cycle. It currently suggests that labour market capacity pressures have faded and that a small degree of slack is emerging. Of the 14 indicators, only three are still signalling capacity stretch: the headline unemployment rate, HLFS employment and monthly filled jobs. We think this reflects the lagged response of employment and unemployment to changes in labour market conditions, rather than a conflicting signal (rear-view mirror).

Figure 2. Capacity indicators



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

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[1] We estimate the NAIRU using three similar models. The range shown here is the range provided by these models, not an uncertainty band, which would be much wider as the NAIRU is unobservable and subject to revision at the end point.

Looking at past slowdowns in the jobs market, the unemployment rate has tended to be the last variable to respond, as is the case now. In previous slowdowns, the variables that first reflected spare capacity in the labour market tended to be business survey measures such as difficulty finding skilled and unskilled labour and labour as a limiting factor, as well as job vacancies and average hours worked. That same pattern is currently evident, which should give the RBNZ confidence that the labour market transition to a disinflationary state has occurred or at least is imminent.

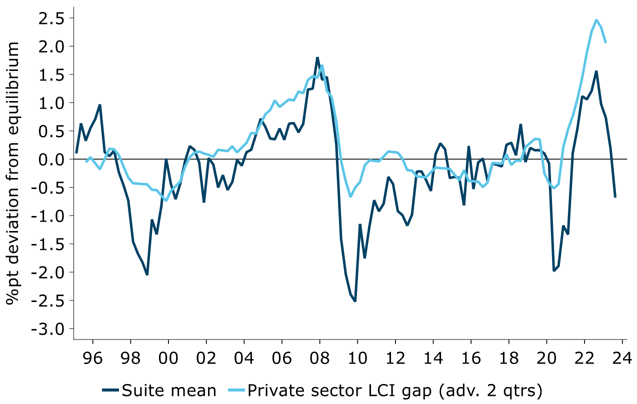
Of course, while a lead is a useful thing in an economic indicator, the match to what you're trying to predict is an important attribute too. Prior to the pandemic, the RBNZ found that the MSE indicators that were most useful for explaining wage and non-tradable inflation (note: not necessarily the most leading indicators) were the Māori and youth unemployment rates, along with the underutilisation and underemployment rates. These variables tend to capture the groups most affected by changes in the business cycle. All four of these indicators are suggesting that a degree of slack has already emerged in the labour market.

Wage pressures should continue to moderate

A necessary condition for inflation to return to target is a normalisation in wage inflation, which is closely tied to capacity pressures in the labour market. Annual growth in the private sector Labour Cost Index (productivity adjusted) reached a record high earlier this year, driven by the intense capacity pressures in the labour market and the resulting competition for workers. With capacity pressures having faded, wage inflation is now slowing a little more rapidly than either we or the Reserve Bank had anticipated.

Annual growth in the private sector Labour Cost Index (LCI) of 2% is generally considered to be consistent with inflation at target, and the gap between the LCI and this level closely aligns with the labour market capacity indicators. Given the lagged response of wages, we're yet to see the full extent of wage disinflation, but the sharp normalisation in capacity pressures suggests it's coming (figure 3). However, the RBNZ needs to see a sustained period of labour market slack, particularly given still-elevated inflation expectations could keep a degree of upwards pressure on wages relative to previous experience. So, while the labour market is no longer in inflationary territory, it isn't yet in "job done" territory (insofar as CPI inflation is concerned). But the recent trajectory is undeniable: monetary tightening is working.

Figure 3. Capacity pressures and wage inflation



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

Where to from here?

With the labour market now at, or near, maximum sustainable employment, it is unlikely to be adding to inflationary pressure. That's great news, but as noted, the RBNZ needs more than that: a period of sustained slack in the labour market is required to bring domestic inflation sustainably lower. And according to our forecast they'll get it. We expect the labour market to continue softening, with the unemployment rate lifting to 5.3% in 2025, taking the heat out of wage pressures along the way and returning domestic inflation to sustainably lower levels.

But there are risks on both sides – risks that we intend to continue weighing up as we monitor the broad suite of labour market indicators outlined on pages 5 and 6.

On the one hand, a loosening trajectory doesn't necessarily mean surprises will necessarily continue to be to the downside. We could be surprised on the relatively robust side of expectations. Indeed, while net migration inflows have played a significant role in easing capacity pressures this year, we are yet to see the full extent of the demand impulse associated with the surge in migration. It's still possible that economic activity and labour market conditions could stabilise at levels inconsistent with the degree of slack required to return inflation to target in an appropriate time frame. In that scenario, rate cuts are a very distant prospect, and indeed the RBNZ could even be brought back to the hiking table, though that is more of a slow-burn story than a near-term risk.

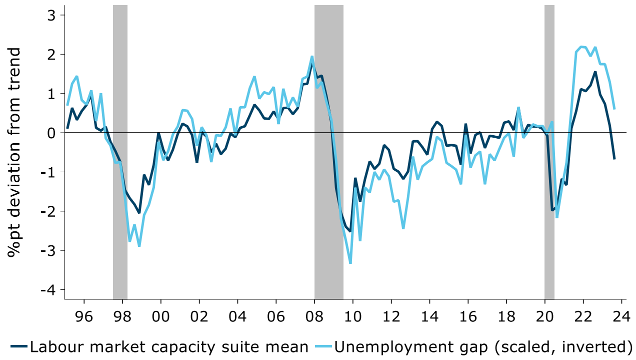
On the other hand, if labour market conditions do deteriorate more (or more rapidly) than expected, to the point where a degree of slack emerges that raises the risk that inflation undershoots the 2% midpoint, that would bring forward the timing of OCR cuts. In our forecasts, we see the labour market reaching sufficiently disinflationary levels in early 2025, in line with when we expect the RBNZ to begin easing. But all forecasts that far out carry with them enormous uncertainty.

For now, the RBNZ absolutely can feel confident that things are currently on track, but that isn't the same thing as complacency that they'll stay that way. A lot needs to continue to go right for some time before the RBNZ can be confident that inflation is back in its box to stay, and the RBNZ will remain alert, surveying incoming data to ensure ongoing disinflation remains a high probability. And the labour capacity suite will be close to the top of the must-watch list through that process.

And lastly, while the new Government has signalled that supporting support maximum sustainable employment will be removed from the RBNZ's economic objectives, we don't think this will impact monetary policy decision making. And we view the broader suite of labour market indicators as valuable for assessing capacity pressures in the economy. It may change the RBNZ's communications a little, but there's no getting away from the fact that the labour market and domestic inflation are wedded in holy matrimony for all of eternity. But to the extent that as unemployment rises there could be a perceived tension between "supporting maximum sustainable employment" and fighting inflation, removing it does arguably slightly smooth the path for holding rates high for longer if the RBNZ deems it appropriate.

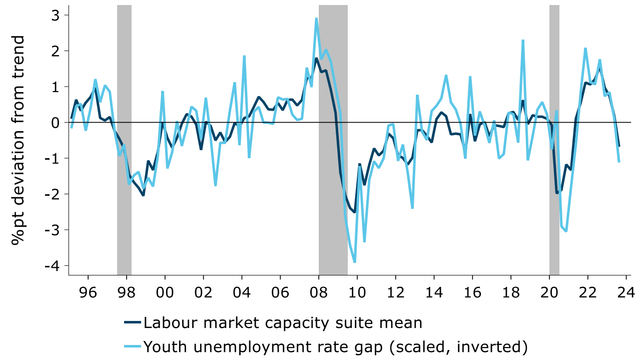
Labour market capacity indicators (grey shading indicates recessions)

Figure 1. Unemployment gap (tends to lag)



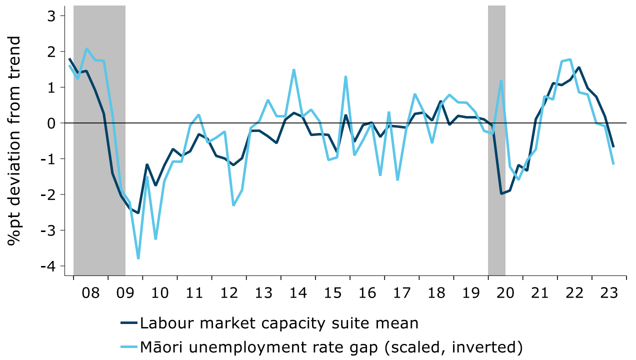
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 2. Youth unemployment gap*



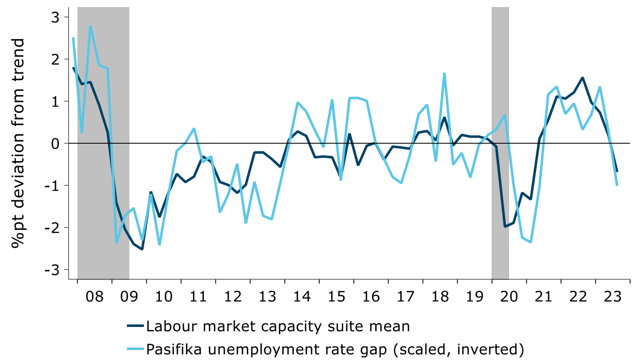
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 3. Māori unemployment gap*



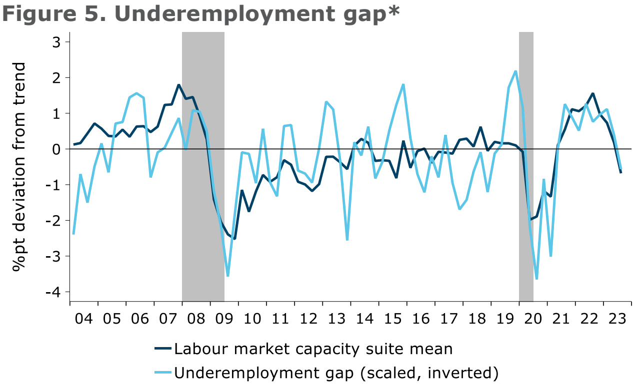
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 4. Pasifika unemployment gap



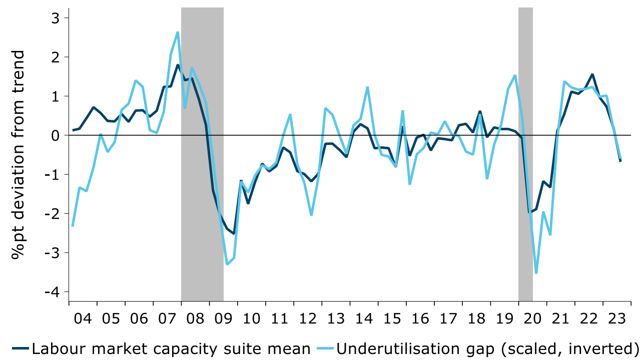
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 5. Underemployment gap*



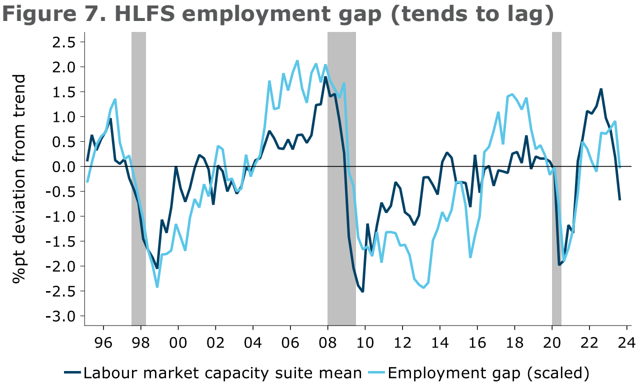
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 6. Underutilisation gap*



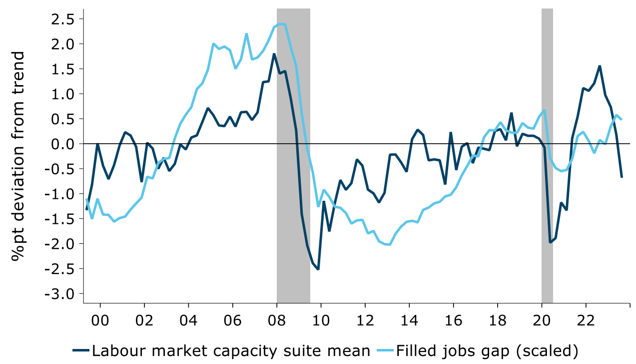
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 7. HLFS employment gap (tends to lag)



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

Figure 8. Filled jobs gap (tends to lag)

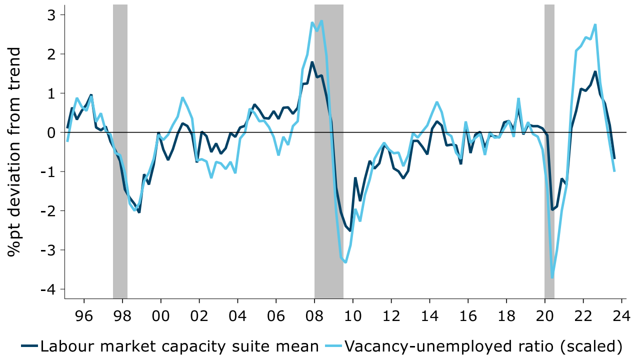


Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

* The RBNZ's own research has shown that these series tend to have the greatest explanatory power for domestic inflation and wage growth.

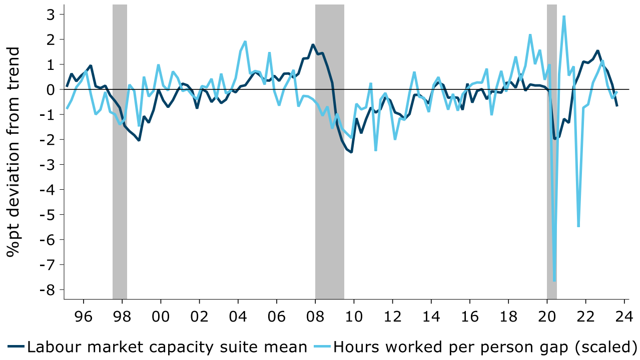
Labour market capacity indicators (grey shading indicates recessions)

Figure 9. Vacancy-unemployed ratio gap (leads)



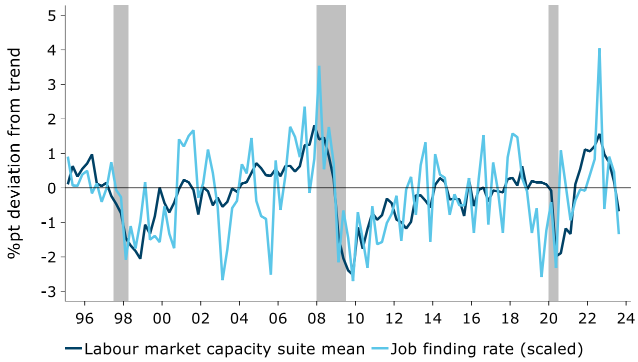
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 10. Hours worked per person gap (leads)



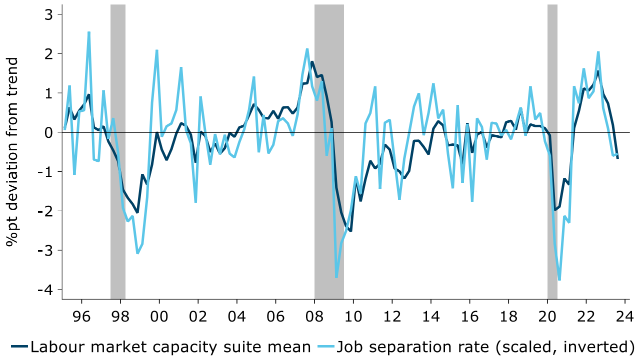
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 11. Job finding rate



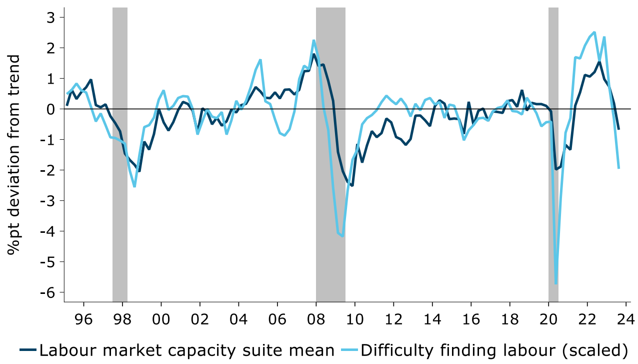
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 12. Job separation rate



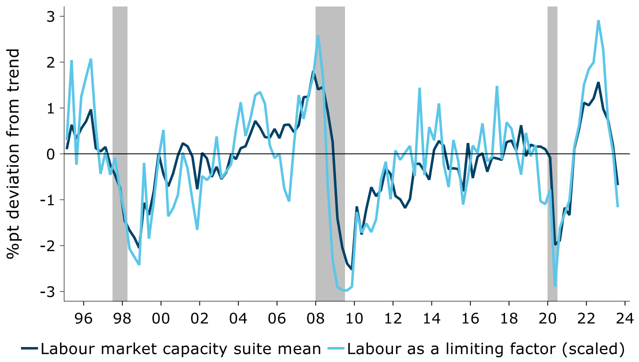
Source: Stats NZ, NZIER, ANZ, RBNZ, Macrobond, ANZ Research

Figure 13. Difficulty finding labour[2] (leads)



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

Figure 14. Labour as a limiting factor (leads)



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

[2] Average of difficulty finding skilled and unskilled labour.

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