Economic Review

New Zealand

5 February 2008

Labour Cost Index and Quarterly Employment Survey: December 2007

Key points

> **Strong wage inflation reflects the tight labour market environment, and will remain a source of upside risk to inflation.**

> **QES employment indicators were strong, pointing to upside risk for this Thursday's HLFS print.**

> **Were it not for credit dislocation, there would be a growing chorus for rates moving up.**

Assessment

Wage inflation reached an all time high at the end of last year. The LCI-based private sector wage measure, which is productivity adjusted, rose by a stronger than expected 1.1 percent in Q4, taking annual wage inflation to 3.5 percent. Industry groups with the largest annual increase were finance and insurance (up 6.3 percent), mining and local government administration (both up 5.1 percent).

The unadjusted LCI, which does not adjust for productivity improvements, rose by 1.4 percent, taking the annual rate to 5 percent. The more volatile (and less reliable) QES wage measure also came in slightly stronger than expected at 0.9 percent for the quarter and 4.0 percent for the year.

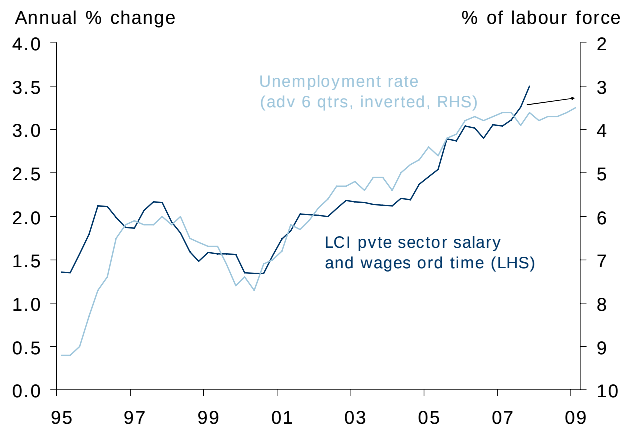
The wage data is consistent with a tight labour market environment. Labour is scarce and business surveys show increasing difficulty in finding both skilled and unskilled workers. A slowdown in net migration is adding to the labour shortage, at a time when employers are still looking to hire. Given this, upward pressure on wage growth will continue to persist for some time. The historical relationship between the unemployment rate and wage inflation suggests elevated wage growth for the next 12 to 18 months.

The QES employment indicators were strong in Q4, suggesting possible upside risk to this Thursday's HLFS employment report. Seasonally adjusted paid hours rose by 1.3 percent in the quarter, to be 2.8 percent higher for the year. Our seasonally adjusted estimate of filled jobs rose 1.4 percent in the quarter to be up 3.5 percent for the year. Both indicate Thursday's HLFS employment growth could be stronger than the 0.5 percent we have forecast, though we note that the relationship between the QES and HLFS can be tenuous at best. Nonetheless, the risk is for a much stronger print on the employment growth front, though a rebound in the participation rate could still mean the unemployment rate stays static.

When we look at the source of the job growth in the QES, three sectors continue to stand out: construction, wholesale trade and property & business services. Those three accounted for 58 percent of the annual increase in filled jobs, and 67 percent of the annual increase in hours paid. With activity in the residential construction sector slowing, retail sales flattening and property related services likely to feel the effects of the softening housing market, those sectors will be unlikely to expand their workforces to the same extent over this year.

	LCI private sector ordinary time		Unadjusted LCI all sectors		QES private sector ordinary time	
	q/q	y/y	q/q	y/y	q/q	y/y
Dec-05	0.7	2.9	1.4	5.4	0.5	5.1
Mar-06	0.7	3.0	1.1	5.7	0.7	4.6
Jun-06	0.6	3.0	1.0	5.5	2.3	4.9
Sep-06	0.8	2.9	1.4	5.1	1.9	5.4
Dec-06	0.9	3.1	1.3	4.9	0.6	5.5
Mar-07	0.7	3.0	0.8	4.5	0.7	5.5
Jun-07	0.7	3.1	1.0	4.6	1.0	4.2
Sep-07	0.9	3.3	1.7	4.8	1.3	3.7
Dec-07	**1.1**	**3.5**	**1.4**	**5.0**	**0.9**	**4.0**
ANZ	**0.9**	**3.3**	**-**	**-**	**0.8**	**3.9**
Market	0.8	3.2	-	-	0.8	4.0

Wages and unemployment rate



Sources: ANZ National, Statistics NZ

Labour income growth will continue to provide late-cycle support to the economy. Gross earnings rose by 7 percent from a year ago, and while this is down from the 9 percent growth recorded in 2006, it is nonetheless still providing a good base of support for consumer spending and the economy generally. While household budgets will continue to get squeezed by rising mortgage servicing costs and higher food and energy prices, ongoing good labour income growth suggests the consumer will not totally shut up shop.

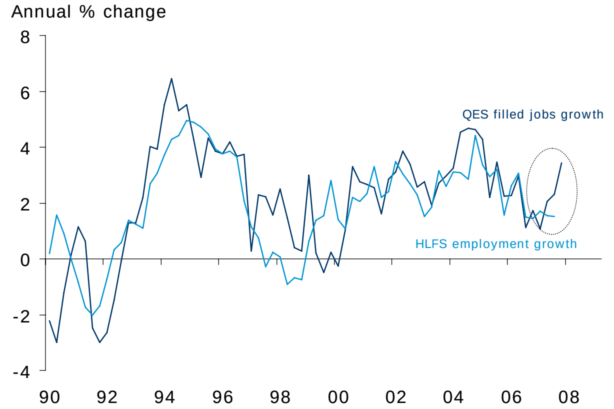
Implications

The labour market has been cited by the RBNZ as a source of upside inflation risk, and today's data will certainly reinforce the Bank's vigilance. Given the lack of inflation headroom that the RBNZ faces, it can ill afford to let cost-push forces from strong wage growth feed into generalised price setting behaviour. Having got on top of the housing market, the labour market now looks to be the RBNZ's next challenge. Of course, the RBNZ is not out to dent job prospects, although a turn in the labour market is a prerequisite to dampening inflation pressure. The RBNZ's job would be made easier if wage increases were matched by productivity gains. This is crucially missing at the moment. Help from policymakers would be of significant assistance on this front.

Today's wage data highlight that, based on domestic factors, there'd be a growing chorus for hikes. Or at a minimum, interest rates remaining at current high levels for a very long time.

Despite this we continue to stick to a late-2008 easing view. The crux of this view is based on the reality that we struggle to see the New Zealand economy (and labour market) remaining immune from global credit events and dislocation. Indeed, with property prices already under pressure, we wonder what the end-game would be if late cycle support from the labour market ceases.

QEF filled jobs vs HLFS employment growth



Sources: ANZ National, Statistics NZ

Disclaimer

ANZ, Level 7, 1 Victoria Street, Wellington 6011, New Zealand Phone 64-4-802 2000 Fax 64-4-496 8639
http://www.anz.com/nz e-mail ecnmcs@anz.com