29 July 2011

Westpac Institutional Bank

Early days

Preview of 2011 Q2 employment data (4 Aug) and wage data (2 Aug)

- **The economy has been growing more strongly than expected this year. Nevertheless, at this early stage of the economic pick-up we only expect to see limited improvement in next week's labour market data.**
- **We are picking a modest fall in employment, and a slight tick-up in the unemployment rate (to 6.7%). We expect moderate wage inflation.**
- **Our picks reflect that the March quarter HLFS and QES reports probably overstated the strength of the labour market.**

March quarter Household Labour Force Survey expectations

	Quarterly % change		Annual
	Previous	Westpac	Westpac
Employment growth	1.4	-0.4	1.5
Unemployment Rate %	6.6	6.7	
Hours worked %	-0.9	1.5	1.6
Participation Rate %	68.7	68.2	

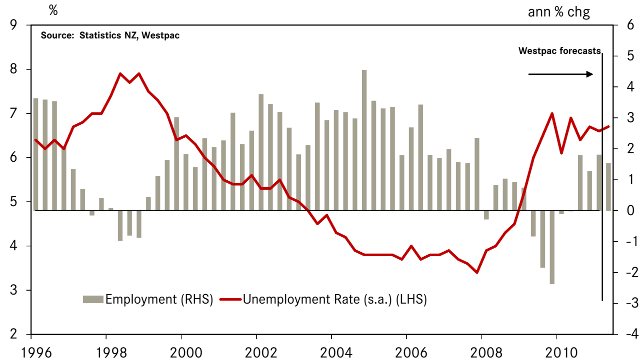
March quarter wage expectations

	Quarterly % change		Annual
	Previous	Westpac	Westpac
LCI – All sectors ex overtime	0.4	0.6	2
LCI – Pvt sector ex overtime	0.4	0.6	2.2
QES wages – All sectors	0.4	1.3	3.3
QES wages – Pvt sector	0.3	1.5	3.4

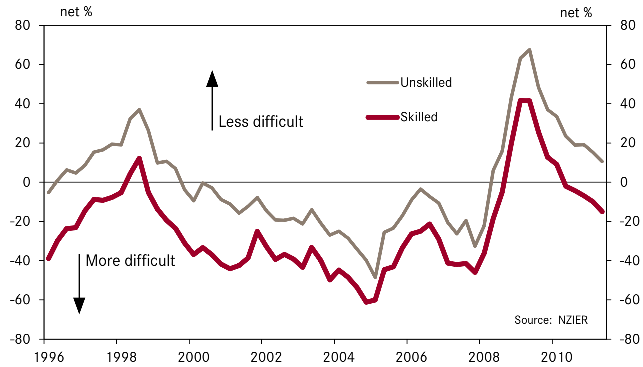
The New Zealand economy has been picking up strongly since late last year. Not only has disruption to economic activity from the February Christchurch earthquake been less than feared, but we've also seen increasing signs of a boda fide recovery in investment and consumer spending.

However, we only expect this recovery to show up in the June quarter labour data to a limited extent. It takes time for stronger economic growth to show through in stronger hiring; and the best information we have, from the NZIER's *Quarterly Survey of Business Opinion* (QSBO), is pointing to a fairly modest improvement in employment trends compared to last year.

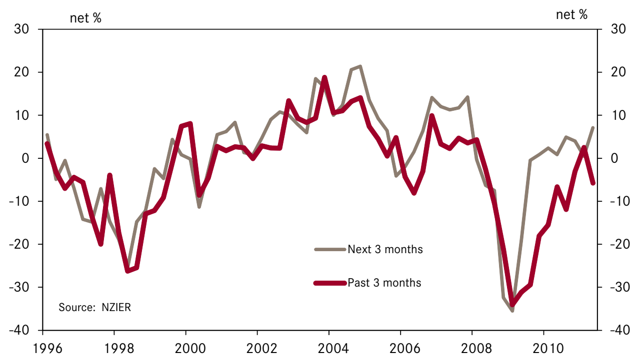
Household Labour Force Survey



Firm's difficulty in finding labour



Employment intentions



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Sufficiently modest, in fact, that we expect the unemployment rate to inch back up. That's likely to change once Christchurch reconstruction gathers pace – by 2012 we're expecting a rapid ramp-up in employment, particularly in construction-related sectors. Other, more forward-looking indicators (such as employment intentions in a range of business surveys) are consistent with this. It's just too early to see much signs of recovery in the June employment data.

Less than meets the eye

When picking our June forecasts we also had to take into account that the March labour market data, plagued by volatility at the best of times, were even less reliable than usual: they didn't take full account of the impact of the Christchurch earthquake, and so they're likely to have overstated the improvement that actually occurred. The Quarterly Employment Survey was surveyed before the 22 February Canterbury earthquake, and quake-disrupted Christchurch was excluded from the Household Labour Force Survey. Those missing earthquake effects (to the extent that they've persisted) are likely to show up in the June numbers.

We think this is particularly relevant when thinking about employment growth, hours worked, and labour force participation. For employment growth, we're looking for a 0.4% decline in Q2 after the official March quarter estimate of 1.4% - and some of this is simply because we think the March estimate was too strong. Our pick is consistent with the QSBO, which is pointing to about 1% employment growth over the entire past half year. We think that's more reliable than taken the March quarter official estimate as given. (The QSBO isn't perfect, but at least the March survey included quake-hit Christchurch.) Canterbury (ex Christchurch) was reintroduced into the HLFS sample one week after the quake, and the Canterbury data hint that the earthquake's impact on Christchurch hours worked, employment, and participation were probably significant. For example, on our seasonally adjusted estimates employment fell 3.5% in the Canterbury region, even excluding Christchurch.

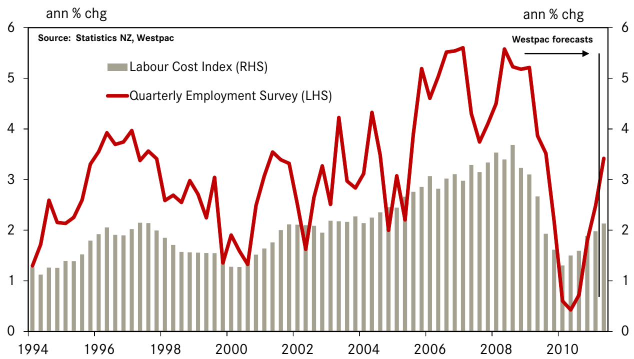
We expect the participation rate to drop back as well, implying a more modest rise in the unemployment rate. Here, the official March quarter estimate of 6.6% was probably less off the mark, and measures of labour market tightness (such as the QSBO's skill shortages) are broadly pointing to something only a little higher. In particular, we're guided by the fact that in March, the quake's impact on the unemployment rate in ex-Christchurch Canterbury was quite small. Of course, Christchurch is likely to have had more businesses severely affected by quake damage than the wider region. (When Westpac did a survey of its business customers in Christchurch, it found that about 5% of businesses reported a permanent impact from the quake.) But of those businesses many would probably be reducing or relocating their operations, not shutting down. We also know that about 900 extra people have been claiming unemployment benefits in Canterbury since December, on seasonally adjusted numbers from the Ministry of Social Development – that's about 0.25% of the Canterbury workforce. Even if the Christchurch unemployment rate had lifted by an extra 1% as a result of the quake, that would add about 0.1% to the national unemployment rate.

For hours worked, we expect a 1.5% rebound after last quarter's 0.9% drop. That looks high, but it still doesn't amount to a labour-led recovery (GDP grew 1.5% over the past half year). Of course, that's likely to change as the reconstruction effort gets going.

Wages and earnings

For wages and earnings, the increase in difficulty of finding labour that firms have been reporting, combined with rising inflation expectations, and the likelihood that we'll see some bounce-back from March's surprisingly soft wage growth, suggest wage inflation somewhat above average for the quarter. Those aren't alarming numbers. The LCI would be 2% higher than a year ago, and the QES average wage would be up 3.4% (remembering that this wage inflation measure doesn't strip out productivity gains).

Private Sector Earnings and Labour Costs



Market implications

In its latest projections, the RBNZ expected the unemployment rate to continue to edge down in June, to 6.4%. Should unemployment remain higher than that, as we and the market expect, this wouldn't dissuade the Bank from withdrawing the 50 basis points worth of 'insurance' cuts that it made back in March, as it signalled in its statement on Thursday. But a still softish labour market would provide some comfort to the Bank given recent elevated survey measures of inflation expectations and pricing intentions – data on which the Bank was pointedly silent on Thursday. Relative to the market, our June quarter labour market expectations are a touch on the soft side, whereas our expectations for wage inflation are somewhat higher.

Looking beyond June, we continue to see a rapid fall in unemployment and a steady increase in wage pressures, and we continue to see a strong risk that the Reserve Bank will end up having to hike to a greater extent than it's been signalling.

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