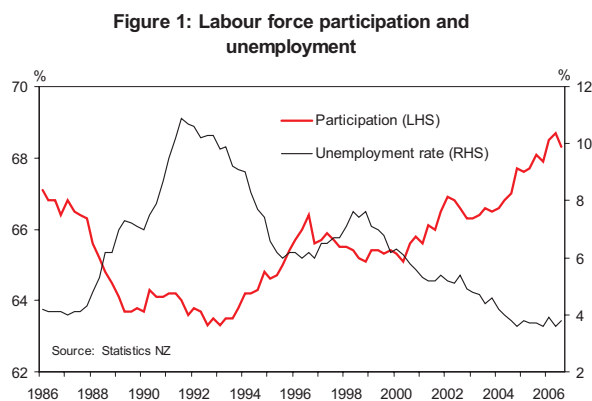


# The will to work

Labour force participation in New Zealand is cyclical

- **Our research suggests that the labour force participation rate is highly cyclical.**
- **If employment growth slows, participation will fall, limiting any increase in unemployment.**
- **If employment remains strong participation could rise, tempering any inflationary labour market squeeze.**
- **Population aging will cause the participation rate to trend downwards in the future.**

The labour force participation rate has confounded New Zealand economists in recent times, surging from 65% in 2000 to 68.3% in September 2006.<sup>1</sup> This flood of new workers helped to forestall serious labour shortages – unemployment has barely budged since 2004, despite a massive 7% increase in employment and just 2% population growth. All this has got macroeconomists very interested in the participation rate. The key question is whether the surge in participation is the start of a new trend, or a cyclical response to the strong labour market. And the answers have very important implications for forecasters and policymakers.

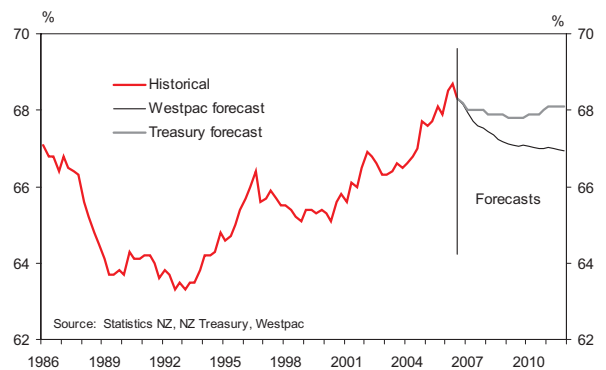


<sup>1</sup> The labour force participation rate measures the proportion of adults aged 15 and over who are either employed or unemployed.

We have undertaken some in-depth research into New Zealand's participation rate, concluding that it is cyclical. Better employment prospects encourage more people to join the labour force. A 1 percentage point (1ppt) increase in employment is estimated to increase the participation rate by 0.3ppts, and is estimated to reduce unemployment by just 0.6ppts. Far from being inexplicable, most of the recent increase in participation can be explained by strong employment growth.

This result is important. Most forecasters in New Zealand are expecting substantially higher unemployment in New Zealand, due to lower employment growth. We agree that employment growth will be low, but we beg to differ on unemployment. Low employment growth would see a cyclical fall in labour force participation, limiting any rise in unemployment. Accordingly, we have adjusted our own forecasts. We now expect the participation rate to fall to 67% over the next three years, and the unemployment rate to remain close to 4%

**Figure 2: Participation projections**



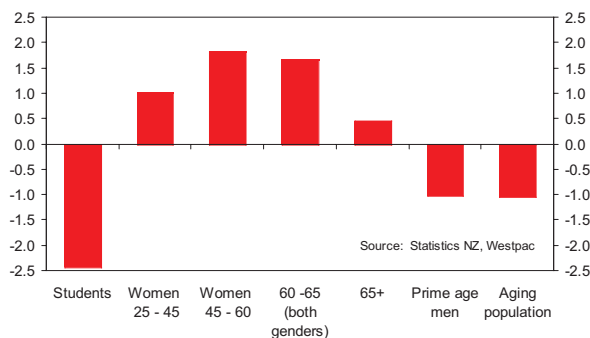
Some economists are more bullish about employment, worrying that unemployment will fall to an unsustainably low level, causing wage inflation to spiral out of control. Again, we beg to differ – New Zealand

is not about to “run out of workers”. If employment growth remains strong, the participation rate could well rise in response. New Zealand could sustain 2% employment growth per annum for the next five years before unemployment fell to 1950s levels (at average migration levels). Continued strong employment growth may not prove as inflationary as the RBNZ fears – the past two years being a case in point.

The paper also reveals that there is no single “trend” in participation. Rather, various offsetting factors have affected participation over the past twenty years, the balance of which has left the aggregate participation rate slightly higher than it was in 1986.

- Female labour force participation has increased dramatically, especially among 45 – 65 year olds. Younger women’s participation rates increased steadily for most of the twentieth century, but stopped trending upwards in the mid-1990s.
- The participation rate of 15-24 year olds has fallen dramatically due to an increase in secondary and tertiary education.
- The participation rate of 60-64 year olds of both genders rose when the age of eligibility for National Superannuation rose from 60 to 65.
- 25-55 year old men’s participation rates have declined slightly.
- The population has aged, with proportionately more people moving into low-participation categories aged over 55, and fewer people in high-participation categories aged between 25 and 55. This has dragged down the participation rate by 1 percentage point over the past twenty years.<sup>2</sup>

**Figure 3: Contributions to change in aggregate participation rate since 1986**



Looking to the future, the long-run trend in participation is almost certainly downwards, due to population aging. A cohort analysis does suggest that participation rates among women aged 50-65 years are likely to rise for another decade at least, adding substantially to the aggregate participation rate. Further decreases in participation among young people will be a minor offset. But the biggest factor will be population aging,

which will knock 1 percentage point off the labour force participation rate in the next five years, and a total of 2.5 ppts over the next decade.

### How we did it

Interested readers can find the full occasional paper on the “Economic reports” page of our website. The study used the Household Labour Force Survey, breaking the data down into 5-year age groups, and separating the genders. For each age/gender group, we estimate how sensitive the participation rate was to the aggregate unemployment rate (averaged over the past six months), capturing the so-called “discouraged worker effect”. We also estimated the historical trends for each group. We then combined the predictions for each age-group into an aggregate forecast of participation.

For us, this research has been enlightening. The New Zealand labour market is more responsive to the economic cycle than a simple read of the unemployment rate would suggest. The prediction of low employment growth but little change in unemployment seemed surprising at first – but it is worth recalling that unemployment has been forecast very poorly by the bulk of New Zealand economists over the past decade. We hope our research leads to better forecasts over the next decade!

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<sup>2</sup> If all age/gender groups had maintained their 1986 participation rates, the aggregate participation rate would have fallen by approximately 1%. Population aging has a substantial effect in New Zealand because the official participation rate includes the over-65s.