NZ labour market: purging the excesses?

- **Prospects for the NZ labour market are fundamental to the outlook for the economy.**
- **Over the next 12-24 months, we expect employment growth to moderate as the excess demand for labour dissipates, economic activity stays modest, and profits remain under pressure.**
- **Much lower earnings growth will act to keep a lid on consumer spending and take some of the heat out of the housing market.**

Compared to previous economic downturns, the NZ labour market is one of the key distinguishing factors – the economy entered the slow patch with a shortage of labour rather than a surplus. Until recently, this has served households well, with employment growth and the housing market more resilient than we expected.

But, while this has been great for households, it has also caused a headache for the RBNZ. The labour market has remained extremely tight, placing upward pressure on wages and heightening concerns of a wage-inflation spiral. While the most recent employment data helped to dispel some of this concern – employment contracted in the quarter, and the unemployment rate lifted – overall labour market conditions remain tight.

So just what is the outlook for the labour market, i.e. are the current tight conditions set to remain the proverbial thorn in the RBNZ's side?

Over the next few weeks we aim to answer this question by looking at the demand and supply of labour separately. In this paper we look at the demand side. We conclude that the recent period of outsized employment growth has largely been the result of a pent-up demand for labour that now looks to be dissipating. Moreover, the key drivers of the demand for labour – economic activity and profitability – suggest that employment growth will slow in the near term.

Demystifying recent trends

For the best part of the last year, the labour market puzzled us with its strength. In fact, despite most labour market indicators suggesting that the demand for labour had eased in the first half of this year, an extra 44,000 jobs were created – astounding when you consider that only 31,000 jobs were created during the whole of 2005. Some of this strength unwound in the September quarter with employment contracting 0.4% and the unemployment rate rising from 3.6% to 3.8%. However, it is worth considering why employment growth remained so strong in the face of weaker economic activity. There are a couple of possible explanations.

Firstly, some of the unexpected strength can be put down to the 2006 Census – Statistics New Zealand employed a team of around 7,000 people to carry out the delivery and collection of Census forms nationwide. This effect looks to have largely unwound in the third quarter, with employment contracting 9,000 and annual growth dropping from 3.1% in the June quarter to 1.5% currently. Nevertheless, employment still remains at a higher level than we expected at the beginning of the year and certainly higher than that indicated by the current pace of economic growth.

Secondly, from 2001 to 2005, skill shortages in NZ were rife, meaning that even though economic activity dictated stronger employment growth, firms were unable to satiate their demand for labour. The result was a massive pent-up demand for labour, reflected in the relative underperformance of employment growth to economic activity during that period *(Figure 1)*. But as economic activity slowed in the latter half of 2005,

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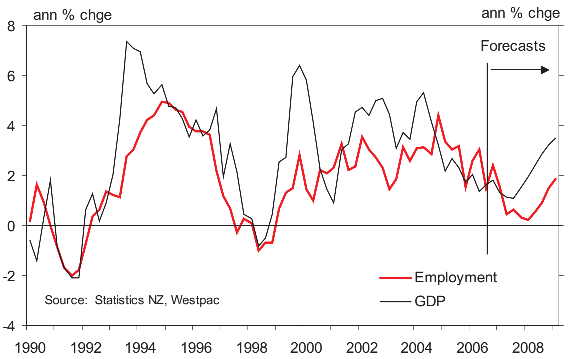
the tight labour market continued to attract more people into paid work. This freed up the supply of labour and firms took advantage of that, continuing to hire staff at a reasonable pace.

Figure 1: GDP and employment

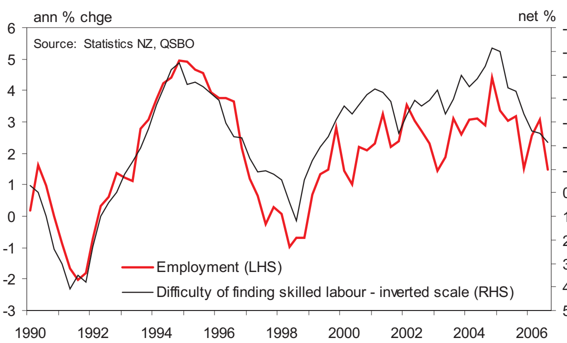


Demand now moderating

However, this pent-up demand for labour now appears to be receding. A key indicator of labour demand pressures within the NZ economy is how difficult it is for firms to find appropriate staff. Business surveys suggest that this still remains an issue, but much less so than a year ago. According to NZIER's latest Quarterly Survey of Business Opinion, a net 21% of firms had more difficulty in finding skilled staff in the September 2006 quarter, compared to 43% in a year ago and 61% at the peak in December 2004. Meanwhile, only a net 7% of firms had more difficulty finding unskilled staff, well down from the peak of 49% in March 2005.

This is a significant development given that these series have proved reliable indicators of employment, wage growth and participation in the past *(Figure 2)*. Moreover, if we consider the difficulty of finding labour as a measure of the balance between demand and supply then certainly the imbalance of recent years looks to be correcting. That is, the excess demand for labour that has been present for some time now looks to have peaked and the implication is that the demand for labour may soon fall below supply.

Figure 2: Employment and difficulty of finding skilled labour

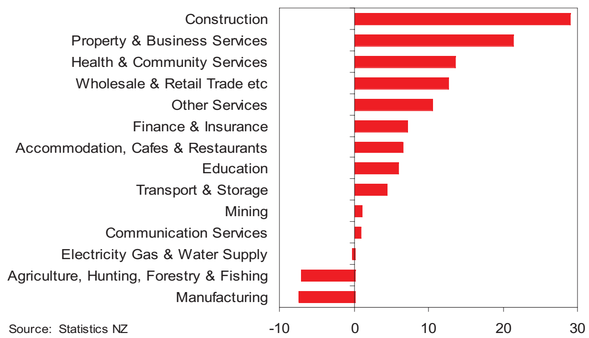


Adding substance to that view is that only 14% of businesses point to the availability of labour as being the single factor most limiting their business expansion. This is down from 26% in the March 2005 quarter. Furthermore, employment growth has been outpacing growth in economic activity for the best part of two years, a situation that is unlikely to persist at a time when profitability is under pressure. Together these factors suggest that a correction in employment growth is due.

Employment by industry

A look at employment growth by industry serves to firm up our view on the direction of employment growth over the next few years. Not surprisingly, this reveals that much of the growth in the past few years has been in our nontradable sectors, particularly the construction and service sectors, both of which are reasonably labour intensive *(Figure 3)*. Construction has had the biggest influence, accounting for almost 30% of all new jobs since 2001, followed by Property and Business services, and Health and Community services. Meanwhile, employment in the primary and manufacturing sectors has been declining.

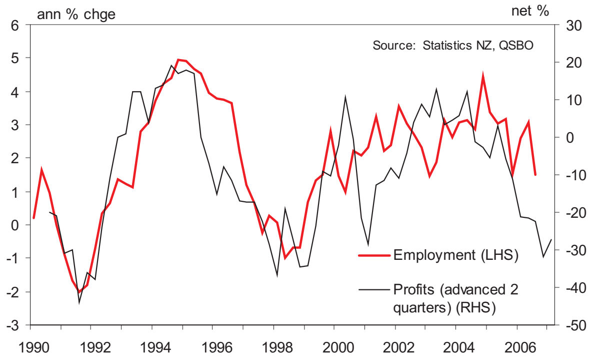
Figure 3: Employment by industry
Contribution to change in past five years



With the construction and service sectors predicted to be the hardest hit over the next couple of years, as the economy transitions from domestic-led growth to an export-sector focus, we expect labour demand to moderate in these areas. In fact, based on the downturn already experienced in construction activity, the growth in construction employment looks set for a substantial rebalancing.

Moreover, if businesses continue to face a profit squeeze over the coming year, as we expect, this will eventually translate into further slowing in labour demand, fewer job opportunities, and greater resistance on the part of employers to deliver high wage growth.

Figure 4: Profits and employment



So what does all this mean?

We expect annual employment growth to slow from 1.5% currently to just over 0.5% by the end of 2007. Thereafter we see little pick up until the end of 2008 when employment growth is expected to again reach 1.5%. How this translates through to the unemployment rate depends on the extent to which the working age population and the labour force grows – i.e. the supply of labour. In a forthcoming paper we explain why we expect lower employment growth to be met by lower labour force participation, limiting any increase in the unemployment rate.

But whether the outcome is a higher unemployment rate or lower participation, the implications are the same – labour earnings growth will be much slower over the next few years. This means continued modest growth in consumer spending and a less resilient housing market in the period ahead.

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