Westpac

Institutional Bank

6 May 2015

Line call

March quarter 2015 labour market review

- Labour demand has remained strong, resulting in solid employment growth in the early part of 2015.
- However, there is still lingering spare capacity in the economy, with the unemployment rate remaining at 5.8%.
- Combined with very low consumer price inflation, lingering capacity in the labour market has resulted in continuing softness in nominal wage growth.
- We expect that the OCR will remain on hold for some time. However, the risk of rate cuts over the coming year has increased.

Strong labour demand...

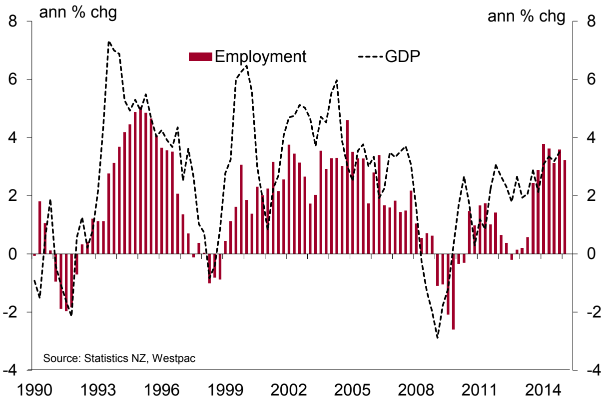
Two things stood out in today's labour market data. First, was the strength in real activity. Employment in the economy was up a solid 0.7% over the quarter, resulting in a 3.2% for the gain for the year. This has seen the proportion of the population in employment rising to its highest level since 2008. And in addition to more people having jobs, they also working more hours, with strong gains in both the HLFS and QES measures of labour hours (respectively up 1.4% and 2% over the quarter). It's all consistent with an economy that's growing at a strong pace, and one where demand for labour is increasing.

...but lingering spare capacity...

However, the second takeout from today's data was that, despite strong growth in output, we've got lingering spare capacity. In March the unemployment rate was 5.8% - unchanged from December's upwardly revised level. Behind this result has been strong growth in the size of the labour force. Continued improvements in the labour market have

	Quarterly actual		Quarterly expected		Annual
	2014 Q4	2015 Q1	Market	Westpac	2015 Q1
Household Labour Force Survey					
Unemployment rate (s.a.)	5.8	5.8	5.5	5.5	-
Employment (s.a.)	0.8	0.7	0.8	0.8	3.2
Participation rate (s.a.)	69.4	69.6	69.4	69.3	-
Quarterly Employment Survey					
FTE employment (s.a.)	0.8	1.7	-	0.7	4.1
Hours paid (s.a.)	0.9	2.0	-	0.9	3.8
Private ave hourly earnings, ord time	1.0	0.0	0.9	1	2.1
Labour Cost Index					
All sectors, ordinary time	0.5	0.3	-	0.5	1.7
Private sector, ordinary time	0.5	0.3	0.4	0.5	1.8
Private, all salary & wage rates	0.4	0.3	0.4	0.4	1.8

encouraged more people to enter the labour force from both on- and off-shore. This has resulted in the labour force growing by a massive 73,000 people over the past year, and has pushed the participation rate to a record high of 69.6%. Participation rate gains has been particularly strong among those aged 19 to 34.



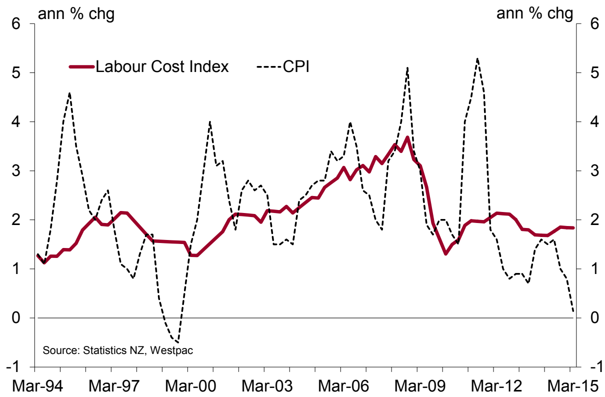
Labour force participation and unemployment

...and low wage growth

Combined with very low consumer price inflation, lingering capacity in the labour market has resulted in continuing softness in wage growth. Private sector LCI wage inflation (including overtime) was just 0.3% in the March quarter, leaving wage rates up 1.7% for the year. We haven't seen any material lift in nominal wage growth since 2008/09 recession.

Nominal wage rates don't give us the whole story however. Low consumer price inflation means that the limited wage increases we've seen have been going much further. In fact, adjusted for changes in purchasing power, wage growth in March was the strongest it's been in over a decade. Limited price increase for many goods and services have effectively put money back in consumers' pockets. This helped support strong growth in spending in the early part of 2015.

Employment and GDPLCI and CPI



RBNZ: Should I stay or should I go?

Today's data highlights the dilemma the RBNZ is facing. Inflation pressures in the economy are soft. And the longer they remain soft, the greater the risk that we see a sustained and material downshift in domestic inflation expectations and pricing behaviour. This would make it harder for the RBNZ to achieve its medium-term inflation target.

But while low inflation makes a cut in the OCR tempting, domestic activity remains very firm. In the early part of the year we've seen strong household spending, and positive indications for business investment. And of course, the housing market is continuing to sizzle away. Rate cuts now would risk super-charging these already strong conditions, potentially creating more inflation down the line.

Today's data have increased the risk of an OCR cut this year. But on balance, we think economic growth and the housing market will remain too strong for the RBNZ to pull the trigger. But we must admit, it will be a finely balanced decision. Any sign that economic growth is losing momentum could tip the balance and cause the Reserve Bank to cut. However, no such sign was apparent in today's data.

Market reaction

Today's data was softer than markets expected. After the data was released we saw the 2-year swap rates fall 3 basis points, and the NZD was down 60 points.

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