ANZ Research

NZ Insight: The Australian labour market and the RBNZ

10 August 2022

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Australian labour market spillovers – a potential problem for the RBNZ

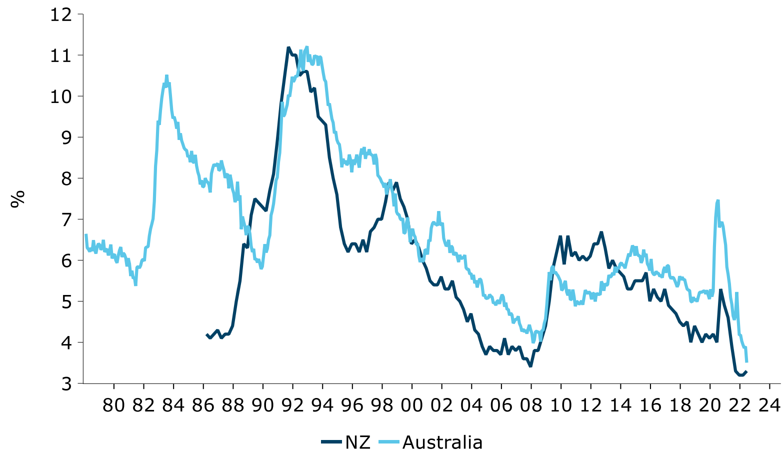
Overview

- The Australian labour market has tightened rapidly in recent months, with the lowest unemployment since the early 1970s, and record-high job vacancies. This is likely to put further pressure on the Kiwi labour market, and make it harder for the RBNZ to bring labour demand back in line with supply.
- But exactly how important are Australian labour market developments for New Zealand? Our analysis suggests "very". Through a simple model we show how an increase in Australian labour demand generates a significant reduction in New Zealand unemployment, while pushing wages, CPI inflation, and Kiwi job ads higher in the following year. In the current context, that means adding fuel to the fire of an already tight labour market.
- With Australian unemployment forecast to fall below 3% by early 2023, this is likely to exacerbate the RBNZ's inflation headache by tightening the vice of capacity constraints in the New Zealand economy, and driving stronger domestic inflation pressures over the next year. It's another reason for the RBNZ to continue on with aggressive 50bp rate rises for the rest of 2022, bringing the OCR to a peak of 4% in November.

Trans-Tasman labour markets have tightened rapidly

The Australian and New Zealand labour markets have heated up significantly in the past 12 months. While both countries saw a significant uptick in unemployment in the initial months of the COVID-19 pandemic, the health and economic responses saw unemployment not just go back to where it was, but fall well below pre-COVID levels (figure 1). In New Zealand, the unemployment rate has been as low as 3.2% – the lowest in the official data (going back to 1986). In Australia, unemployment is now 3.5% – the lowest since 1974.

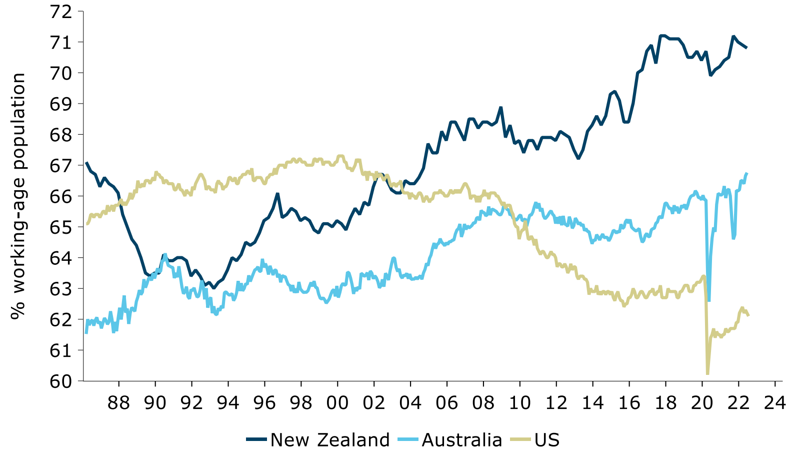
Figure 1. Unemployment rates



Source: ABS, Stats NZ, BLS, Macrobond, ANZ Research

What's even more impressive about these labour market recoveries is that the labour force participation rate is at (or near) records highs for both countries. In New Zealand, participation is holding strong at 70.8%, while in Australia, it has increased to 66.8% – higher than the pre-pandemic peak of 66.3%. That's in stark contrast to the US, where the participation rate has remained stubbornly below 2019 levels (figure 2). The data point to the sheer strength of the demand permeating the Australian and New Zealand labour markets. Despite very high labour force participation, we still simply can't come close to meeting the insatiable demand for workers.

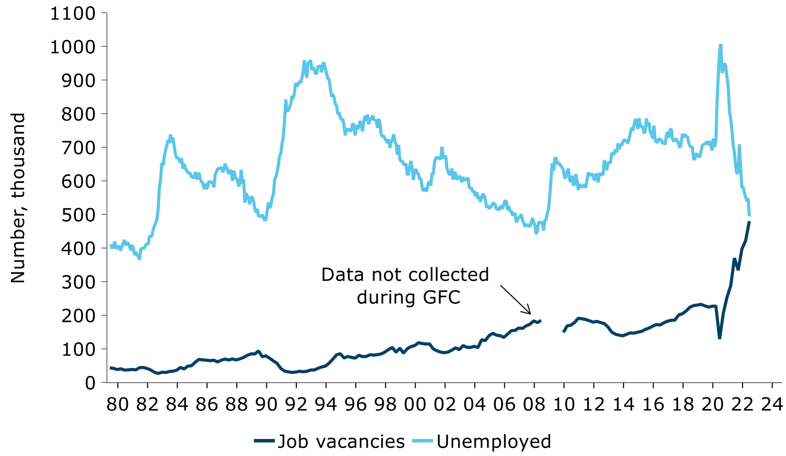
Figure 2. Labour force participation rates



Source: ABS, Stats NZ, BLS, Macrobond, ANZ Research

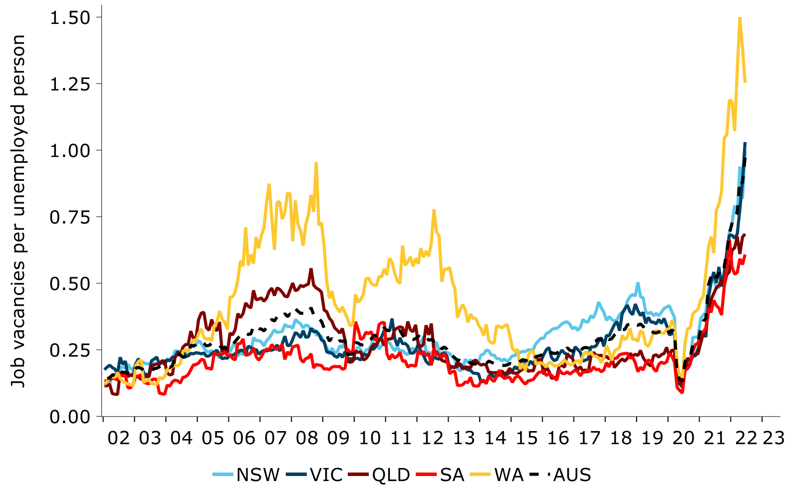
Zooming in on Australia, recent data have shown a serious intensification of demand pressures, at both a national and state level. ABS data shows that there are now almost as many vacant positions as there are unemployed people in Australia – an unprecedented level of labour demand (figure 3). The tightening in the labour market has been broad-based, with job vacancies relative to unemployment increasing in all the largest states (figure 4) and job vacancy rates rising across all industries.

Figure 3. Australian unemployment and job vacancies



Source: ABS, Macrobond, ANZ Research

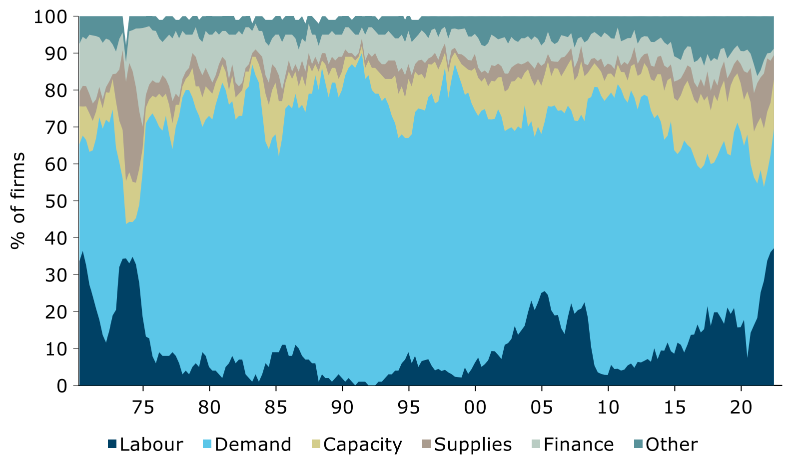
Figure 4. Job vacancies per unemployed person by Australian state



Source: ABS, Macrobond, ANZ Research

In Q2, 88% of Australian businesses reported that the lack of labour supply/suitable labour was a constraint on output, according to NAB's quarterly business survey. This compares with a peak of 72% during the mining boom. It's a similar story in New Zealand. The Q2 QSBO provides a long-term perspective on just how much of a constraint labour is on production at the moment, with more firms highlighting labour as the primary constraint compared than at any time since at least the early 1970s (figure 5).

Figure 5. Factors most limiting production in New Zealand



Source: NZIER, Macrobond, ANZ Research

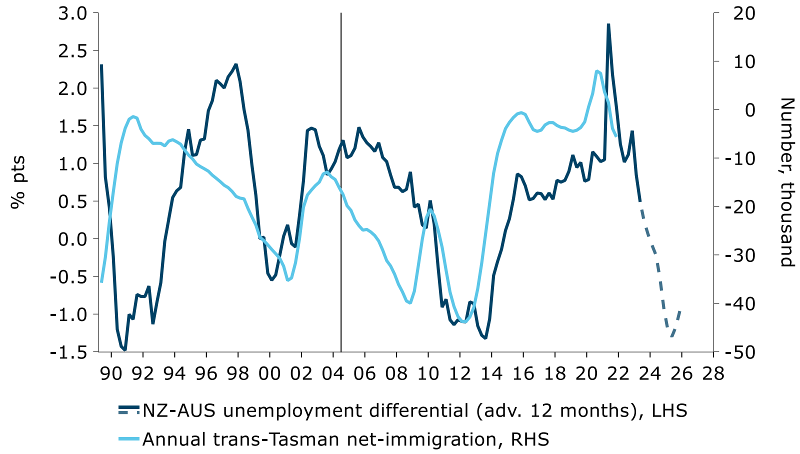
The large volume of unfilled vacancies in Australia means their labour market will likely continue to tighten even as higher inflation and interest rates weigh on demand. We now expect Australian unemployment to fall below 3% by early 2023, with underemployment also to fall further this year.

Newly arrived skilled migrants, temporary visa holders, students and backpackers are now adding to the supply of workers in Australia. But they also add to already-strong demand for goods and services in the economy, lifting labour demand above where it would have been otherwise. So, while the return of migration improves labour mobility and matching, it doesn't necessarily mean the gap between demand and supply is going to close quickly. The same dynamic applies to New Zealand.

What are the implications for New Zealand?

The Australian labour market is quite important for New Zealand, given its accessibility, relative proximity, and much larger size. A simple chart of trans-Tasman net immigration against the unemployment differential between the two countries shows this. When the Australian labour market tightens relative to New Zealand, you often then see an increase in emigration to Australia in the following year (figure 6). And considering how inflationary the Kiwi labour market already is, it's clear that increased labour demand from Australian employers is only going to put more momentum into wage and CPI inflation in New Zealand.

Figure 6. NZ-Australia unemployment differential and Trans-Tasman net migration



Source: ABS, Stats NZ, Macrobond, ANZ Research

Note: With the removal of departure cards, we no longer have timely data on trans-Tasman net migration. In figure 5, Stats NZ's estimate using ABS data is shown beyond 2004, while before 2004, we use the discontinued intentions-based migration data to back-cast.

But how important are Australian labour market developments for New Zealand's labour market? To try to answer this question, we run a simple model.[1] It shows that an increase in Australian job vacancies above their trend level results in an increase in emigration to Australia from New Zealand (ie more negative trans-Tasman net migration, figure 7a). The consequences of this are a reduction in the New Zealand unemployment rate (figure 7b), higher wage growth (figure 7c), higher CPI inflation, and an increase in job ads posted in New Zealand. Essentially, increased Australian demand for workers turns up the heat in the Kiwi labour market by pulling workers over the ditch.[2]

[1] Modelling details: We use a simple SVAR, identified recursively. In order, the variables are Australian job ads (ANZ data), Australian unemployment rate (ABS), trans-Tasman net migration (Stats NZ/ABS/ANZ estimate), NZ job ads (MBIE), NZ unemployment rate (Stats NZ), NZ CPI inflation (Stats NZ), and NZ LCI private sector wage inflation (Stats NZ). The vacancy and unemployment data are detrended, trans-Tasman net migration is expressed as a share of the working-age population, and the final two variables are annual percent changes. CPI inflation is adjusted for the 2010 GST hike, and LCI wage inflation is adjusted to exclude the larger-than-usual minimum wage rises since 2018 and carer wage settlement in 2017. The trans-Tasman net migration variable is constructed from Stats NZ's estimate (in the absence of departure cards), and uses the discontinued departure card data prior to 2004. The model results were almost identical with or without migration included, but it's an important channel to capture, despite the data issues. The VAR has a constant and two lags. The BIC suggested a VAR(1), but the reduced-form residuals were serially correlated. With a VAR(2) we fail to reject the null of no autocorrelation, and the largest eigenvalue of the companion matrix is less than 1, so the VAR is stable. Our dataset spans Q3 1999 (start of ANZ Australian job ads data) to Q4 2019 (to avoid COVID volatility and the border closure). The results were consistent whether we estimated the VAR using first differences, annual percent changes, or our main specification (with de-trended labour market variables).

[2] Interested readers can see the full set of impulse response function graphs underlying these results in the Appendix.

Probably the most interesting result is just how persistent these impacts are. As figure 6 shows, it takes 3-4 quarters for the peak impact of Australian labour demand to fully flow through to New Zealand. Applying that timeline to 2022, it means the full effect of the labour market tightening we've seen in Australian over Q2 may not be fully realised until Q1 or Q2 next year, or even later (if historical relationships in the data have made it through COVID unscathed, which admittedly could be a bold assumption).

Response of trans-Tasman net migration, NZ unemployment and NZ wage growth to a one standard deviation increase in Australian job vacancies

Figure 7a. Trans-Tasman net migration

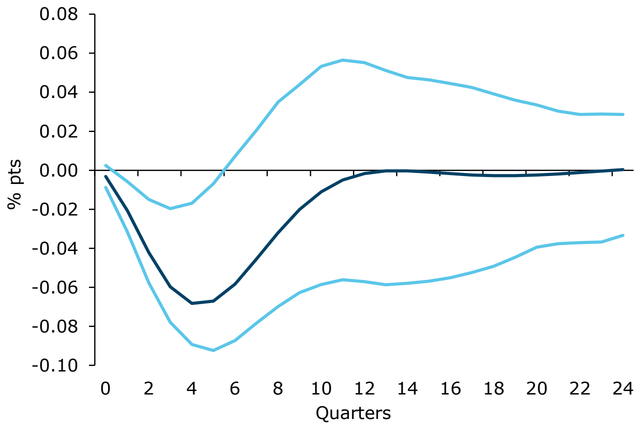


Figure 7b. Unemployment

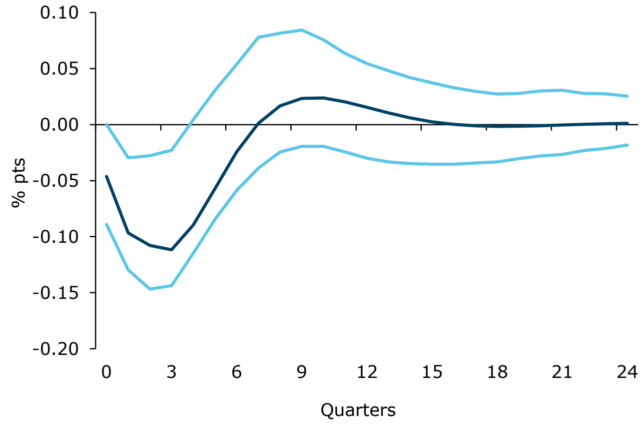
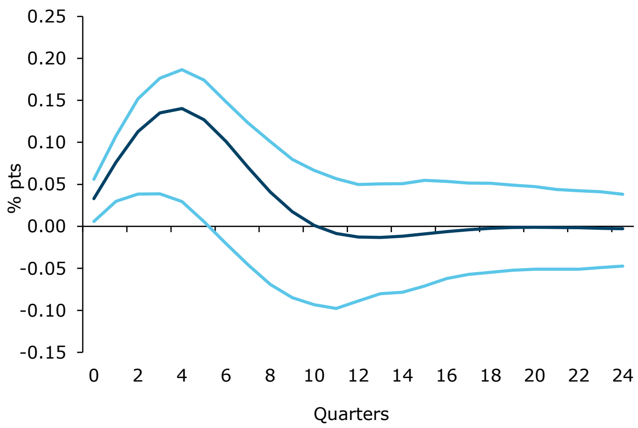


Figure 7c. Annual wage inflation



Source: Author estimates, ANZ Research

Note: The dark blue line shows the estimated response of trans-Tasman net migration, and NZ unemployment and wage inflation to a one standard deviation increase in Australia job vacancies above their trend. The light blue lines show 95% confidence bands. The full set of responses are available in the Appendix.

Australian labour market conditions clearly have a significant impact on the New Zealand economy by further increasing demand pressures, and luring Kiwis overseas. But *how* important are they, in the context of everything else that's going on? Our analysis suggests "very". Figure 8 shows how important Australian unemployment and job vacancies are for explaining variation in Kiwi wages and unemployment at different horizons (at least according to our simple model).

In the shorter run, Australian labour market variables account for very little of the variation in Kiwi wages. In fact, in the short run, current wage growth is almost completely explained by previous wage growth (figure 8b). That's consistent with how 'sticky' wages tend to be, both when they're growing slowly (as we saw after the GFC), or when they're growing quickly (as they are now).

In the long run, that wage 'stickiness' matters a lot less - and Australian job vacancies and unemployment combined explain about 40% of the historical deviation in Kiwi wage growth from its average. That sounds like a lot – and it is. But it's a reflection of just how important trans-Tasman labour market dynamics are for understanding what's going on in New Zealand.[3] What's interesting is that the model attributes very little of the variation in Kiwi wages to net migration directly (less than 5% in the longer run). That's not to say that migration is unimportant or that there's something fundamental missing from the model. Rather, it shows that Australian labour demand is the underlying driver behind both stronger wages and increased emigration.

Turning to unemployment in New Zealand (specifically, the gap between unemployment and its trend), it turns out Australian labour market dynamics matter a lot here as well. As with wages, Australian job vacancies and unemployment start to matter more only at longer horizons. That makes intuitive sense – moving overseas for work is a big deal (both for you and your employer), so you would expect a delay from the initial increase in Australian demand to the impact on Kiwi labour market conditions. The model attributes about 27% of the long-run variation in New Zealand unemployment around its trend to Australian labour demand (job vacancies), and about 7% to Australian unemployment (figure 8a).

Decomposition of New Zealand unemployment and wage growth at different horizons[4]

Figure 8a. NZ unemployment

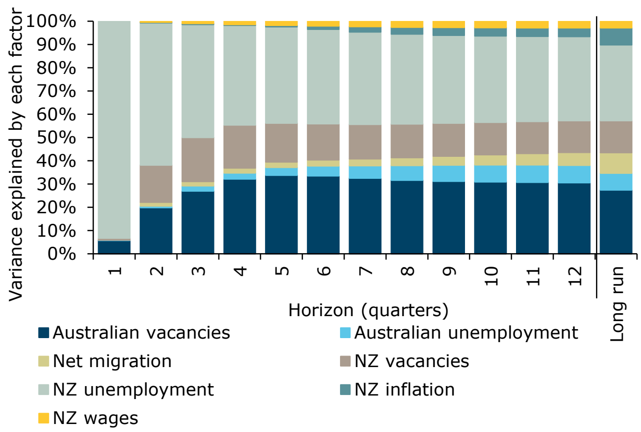
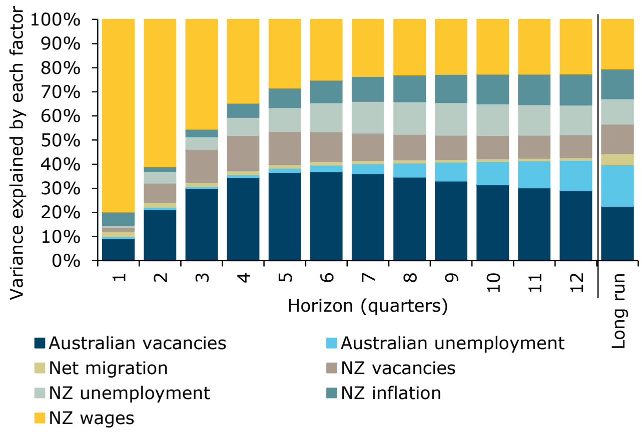


Figure 8b. NZ wages



Source: Author estimates, ANZ Research

So far, we've explored how on average, an increase in job vacancies in Australia triggers a tightening in the New Zealand labour market (with the impact taking 3-4 quarters to peak – figure 7). And in the longer run, Australian labour market conditions drive about 40% of the deviation of Kiwi wage growth from average, and 35% of the variation in Kiwi unemployment around its trend (figure 8).

But averages don't tell us much about what's going on at any point in time. Figure 9 shows how Australian labour market dynamics have contributed to wage inflation in New Zealand over time. It's notable that over the mid-

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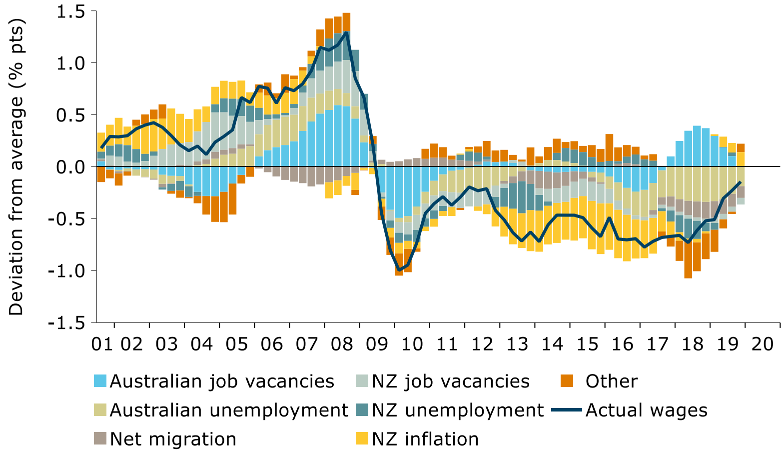
[3] An RBNZ Analytical note also found a very significant role for the Australian labour market in explaining New Zealand wage growth. The paper found that above-trend unemployment in Australia over the mid-2010s was a significant factor behind below-average wage growth in New Zealand.

[4] This is the forecast error variance decomposition (FEVD) of wage growth and the unemployment rate gap – a way of working what proportion of the variability in a variable (like wages) at different horizons can be explained by the structural shocks in the model (eg Australian labour demand shocks). The long-run estimate is obtained by simply running the decomposition for a long horizon until the results stabilise.

2000s (before the Global Financial Crisis), strong Australian labour demand, low Australian unemployment, and high New Zealand inflation were very significant drivers of the above-average wage growth we saw. Low unemployment and high job vacancies domestically in New Zealand also supported wage growth over this time.

Post-GFC, the model suggests that two key factors driving below-average nominal wage growth in New Zealand were low CPI inflation, and a soft Australian labour market (particularly in the wake of the end of the mining boom). By the end of 2019, unemployment in New Zealand had dropped far enough that it was just about starting to push wage growth towards above average levels (blue-green bars). That's consistent with the RBNZ's assessment at the time that the labour market was close to (if not slightly above) maximum sustainable employment. We end our analysis in 2019 since the border closure meant that for most of the past two years, the Australian labour market was restricted from having much impact on NZ.

Figure 9. Historical decomposition of New Zealand wage growth



Source: Author estimates, Stats NZ, Macrobond, ANZ Research

The bottom line from all this analysis is that historically, New Zealand's labour market fortunes have been inextricably intertwined with Australia's, given the work rights each country grants to the other's citizens. That relationship was largely put on ice due to COVID-19 and the resulting border closure. But as restrictions ease and travelling to and from New Zealand gets easier, what's going on in Australian labour markets has become important for New Zealand once more, and in particular for the RBNZ as they battle to extinguish the domestic inflation pulse.

Before moving on, we should note that this modelling is all done on pre-COVID data. And it's also a model that by construction can't capture every single macroeconomic relationship out there. But even taking the results with a decent pinch of salt, it's a clear warning for the RBNZ that as the Australian labour market continues to heat up and pull workers offshore, it will only add to the pressure cooker of capacity constraints facing the New Zealand economy. That's a big concern for the RBNZ considering that core inflation measures currently range from 4.8-6.1%, headline inflation is at 7.3%, and private sector wage growth has surged to 7.0%.

So what does it mean for the economic outlook?

The analysis presented so far shows that when the Australian labour market tightens, this flows through to a tighter labour market and higher inflation in New Zealand over subsequent quarters, by pulling New Zealand workers offshore. The Australian labour market has already improved significantly over 2022, with unemployment dropping to 3.5% (the lowest print since 1974) and job vacancies surging to record highs. By itself, this would be enough to generate further labour market pressure in New Zealand over the next year.

But we also don't think the Australian labour market is done tightening just yet. The almost half a million job vacancies across the economy represent a substantial gap between labour supply and demand. Consequently, as higher inflation and rising rates curtail demand growth, it will still take time for this gap to close enough to put upward pressure on unemployment. We now forecast Australia's unemployment rate to drop below 3% by early-2023 and still be in the low-3s by the end of that year. Given the 3-4 quarter lag it takes for labour market developments in Australia to fully flow through to New Zealand, it suggests the Kiwi labour market will be feeling the strain from strong Australian labour demand over all of 2022 and into 2023.

The RBNZ noted in the May MPS that "employment remains above its maximum sustainable level" (ie the level of employment that can be achieved by monetary policy, without generating accelerating inflation). With Australian employers only adding to demand for Kiwi workers, the highly inflationary mismatch between labour supply and demand in New Zealand is unlikely to be resolved quickly. Unfortunately, that means the RBNZ will need to keep aggressively hiking interest rates to bring demand and supply back in line. We think that will require 50bp OCR hikes at each meeting left in 2022, bringing the OCR to a peak of 4% in November 2022.

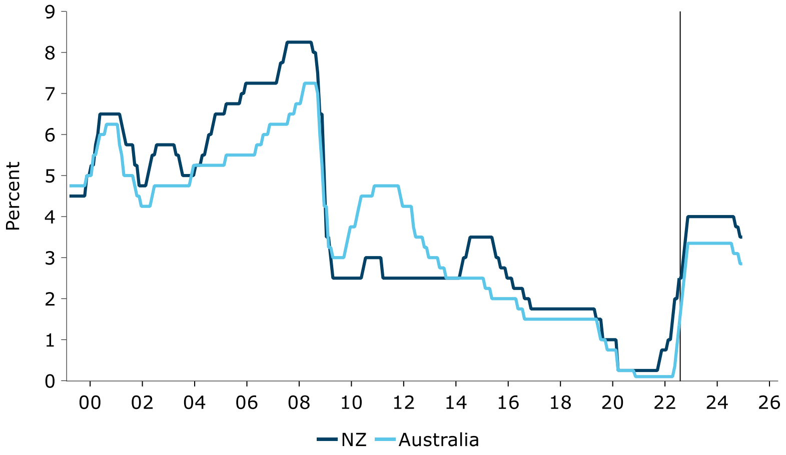
We're forecasting that the New Zealand unemployment rate will remain low at 3.3-3.4% in coming quarters, before rising as the RBNZ's rate hikes flow through to the labour market. That implies the Australian unemployment rate dipping below New Zealand by year end, for the first time since the mining boom (figure 10).

Figure 10. NZ and Australian unemployment forecasts

Source: ABS, Stats NZ, Macrobond, ANZ Research

One thing to consider is that the Reserve Bank of Australia is also set to increase interest rates aggressively over the rest of 2022, bringing their cash rate to 3.35% by year end (figure 11). To the extent that that dents Australian labour demand, it should take some of the pressure off New Zealand's labour market. However, such is that mismatch between labour demand and supply in Australia that it's unlikely we'll see a significant softening in the labour market there until 2024.

Figure 11. NZ and Australian central bank policy rate forecasts



Source: RBNZ, RBA, Macrobond, ANZ Research

The takeaway from all this is that domestic and international tightness in labour markets is unlikely to fade in the near term. Even if labour demand starts to ease, it will take a significant drop in job vacancies before labour markets are anywhere close to being consistent with low and stable inflation. For both the RBNZ and RBA, that speaks to ongoing aggressive hikes for the rest of the year.

One major caveat to all this is that labour market developments are typically quite backward looking. That is, current movement in unemployment and hiring is a reflection of previous strength in the economy (since the labour market is often one of the final parts of the economy to adjust to changing economic tides – employers take time to be convinced they should take on more staff, or let current workers go). So when looking at the outlook for monetary policy, it's important to keep an eye on timely economic indicators (retail card spending, employment intentions, consumer and business confidence etc) for signs that momentum is waning. It's our expectation that such signs will become clearer as the year goes on, prompting the RBNZ to hold off on further rate hikes once the OCR reaches 4% in November. The housing market is softening, consumers are being squeezed by high interest rates and declining real wages, and demand could easily start to fall away faster than expected. But how quickly inflation will recede once that happens is very much an open question.

Technical appendix

Figure 12 plots the impulse response functions of each variable in the VAR in response to a one standard deviation increase in Australia job vacancies (ie a labour demand shock). 95% confidence intervals are shown in the light blue. The ordering of the variables in the VAR is the same as the panels in figure 12.

Responses to a one standard deviation increase in Australia job-vacancies above their trend

Figure 12a. Australian job vacancies

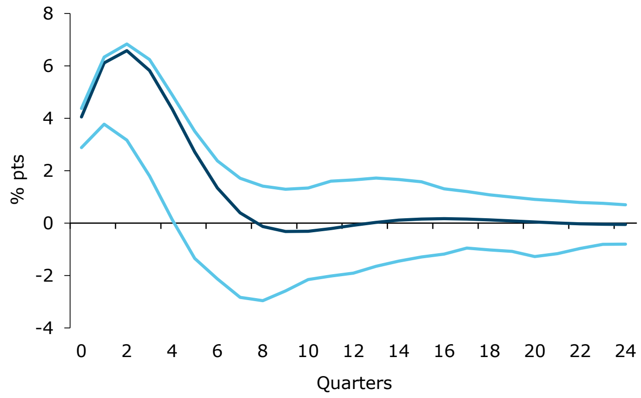


Figure 12b. Australian unemployment

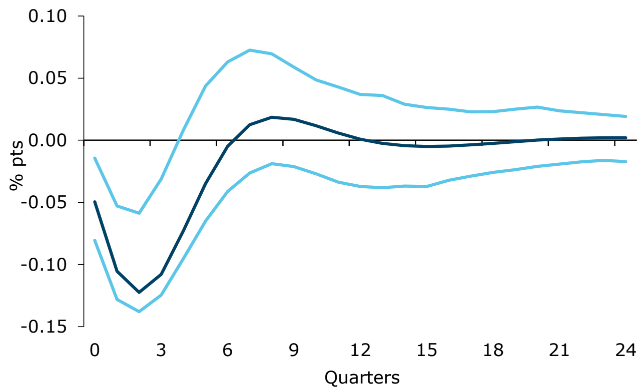


Figure 12c. Trans-Tasman net migration

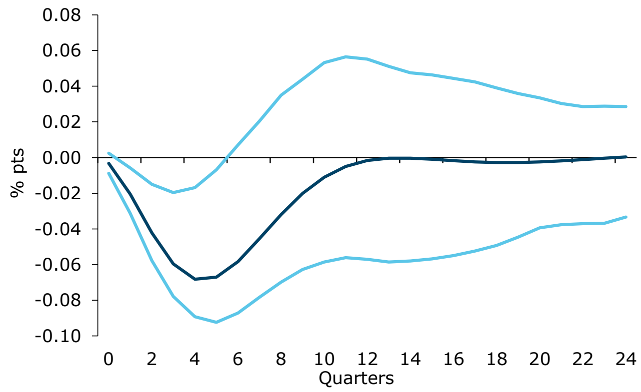


Figure 12d. NZ job vacancies

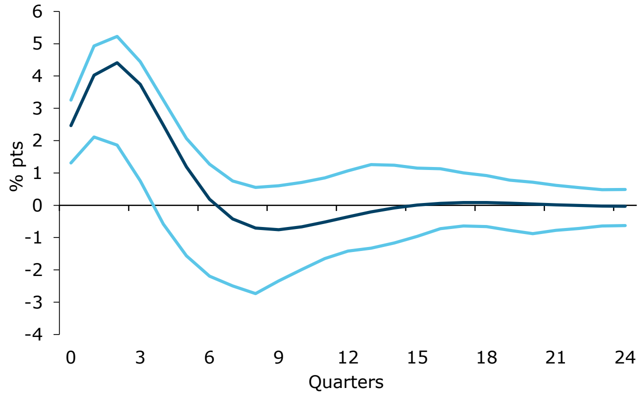


Figure 12e. NZ unemployment rate

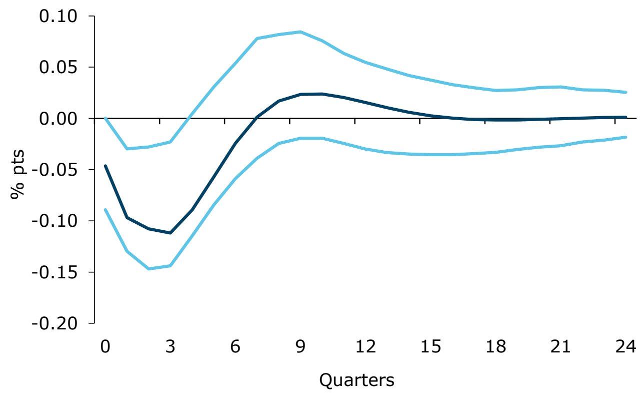


Figure 12f. NZ CPI inflation

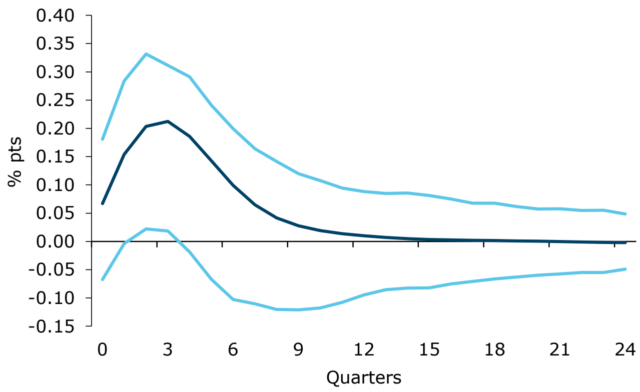
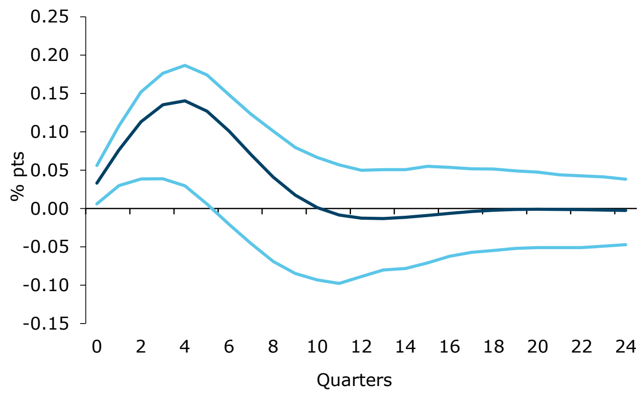


Figure 12g. NZ wage inflation



Source: Author estimates

Note: Light blue lines denote 95% confidence intervals.

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