



**RODNEY'S RAVINGS** take an open-minded and at times irreverent look at topical economic issues. Unlike our pay-to-view reports, that are for the eyes of subscribers only, the **RAVINGS** are free and you may forward them to other people. You can sign up to the **RAVINGS** and for notification about forthcoming **Property Insights** and **Property Research** reports on our website – <http://www.sra.co.nz/lists/>.

## **RODNEY'S RAVINGS**

### Unemployment prospects and implications

#### **EXECUTIVE SUMMARY**

The labour market is at the heart of the economy. Employees' income is the largest component of income in the economy making the labour market central to economic growth prospects. Compensation of employees is the largest production costs for the average firm making the labour market critical to inflation and interest rate prospects. In general economists are poor at predicting labour market prospects but with the aid of leading indicator analysis we provide superior insights into employment and income growth prospects in our monthly **Interesting Times** reports (visit <http://www.sra.co.nz/interesting.html> for information on these reports). So what are the leading indicators currently saying about prospects for the unemployment rate and what does this imply for economic growth, inflation and interest rates?

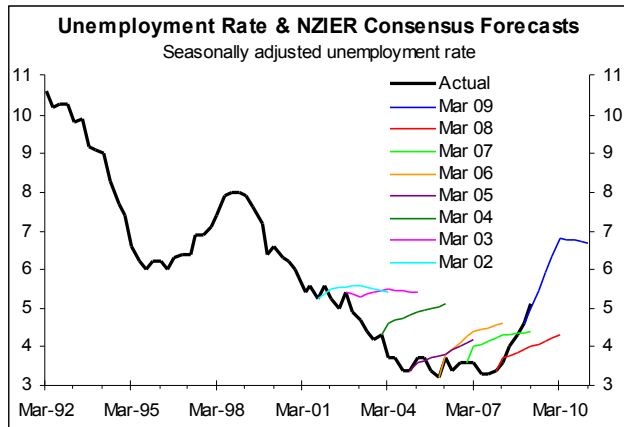
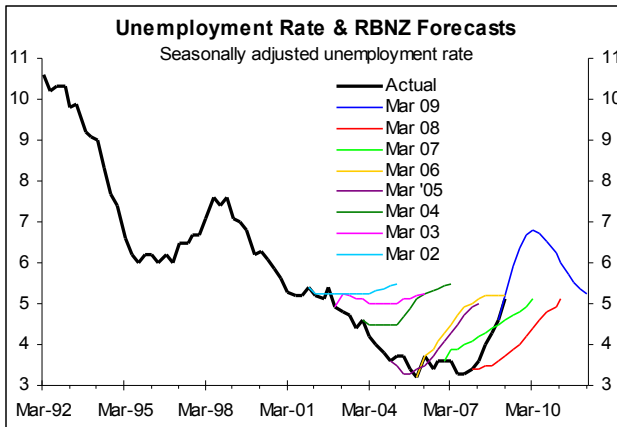


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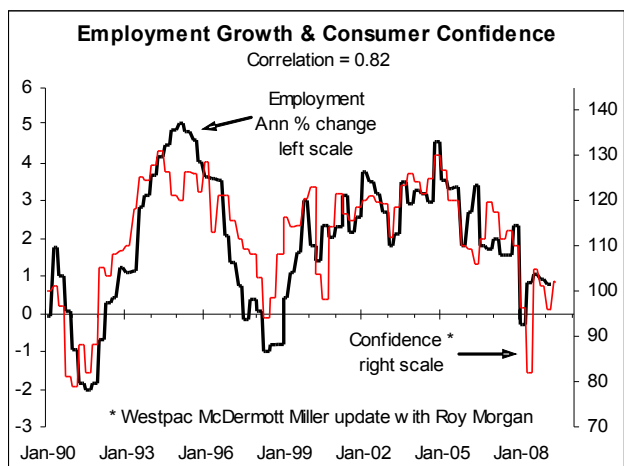
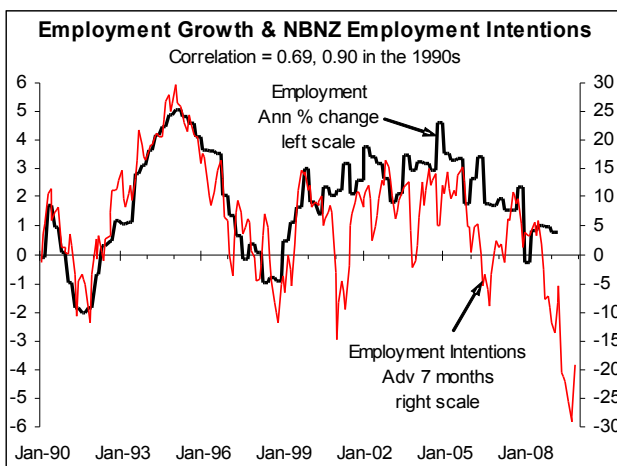
### What are the economists predicting for the unemployment rate?

The dark blue line in the left chart below shows what the RBNZ predicted for the unemployment rate in the March Monetary Policy Statement (if you have a case of insomnia to cure click on the following link to the full statement - <http://www.rbnz.govt.nz/monpol/statements/mar09.pdf>). The dark blue line in the right chart shows the average prediction for the unemployment rate by the 10 economic forecasters surveyed by NZIER in March (the following link will take you to where the consensus forecast live on NZIER's website - [http://www.nzier.org.nz/Site/Publications/Consensus\\_forecasts.aspx](http://www.nzier.org.nz/Site/Publications/Consensus_forecasts.aspx)). It is time for economic forecasters to celebrate because having incorrectly predicted that the unemployment rate would increase between 2004 and 2007 (see Mar 04 to Mar 07 coloured lines in the charts) their forecasts are finally coming true.



Most business surveys including surveys of employment intentions are still well below average so you don't need to be a rocket scientist to predict that the unemployment rate is likely to increase over the next couple of quarters from the 5% rate recorded in the March quarter. Some economic forecasters appear to be taking the negative employment intentions surveys at face value but there are reasons to question how useful they are currently for predicting near-term employment growth prospects. The left chart below uses the NBNZ survey of employment intentions as a leading indicator for annual employment growth. The best fit is with the red employment intentions survey line advanced or shifted to the right by seven months. In the 1990s the survey was almost a perfect leading indicator for employment growth with a correlation of 0.9 (1.0 being a perfect fit), but since 2000 it has a dubious track record. Three times since 2000 there have been temporary sharp falls in employment intentions that haven't been followed by negative employment growth – 2001, 2003/04 and 2006-07. While based on the negative employment intentions in 2008 employment growth in the 2009 March quarter was supposed to be around -2% versus the 0.8% increase reported by Statistics New Zealand (SNZ).

The employment intentions survey is predicting that annual employment growth will hit around -5% in the September quarter before starting to recover in the December quarter. This is what would be required to see the unemployment rate increase to the 10% or so rate some are predicting. But the right chart below suggests there is reason to believe that the unemployment rate may not get above 6%.

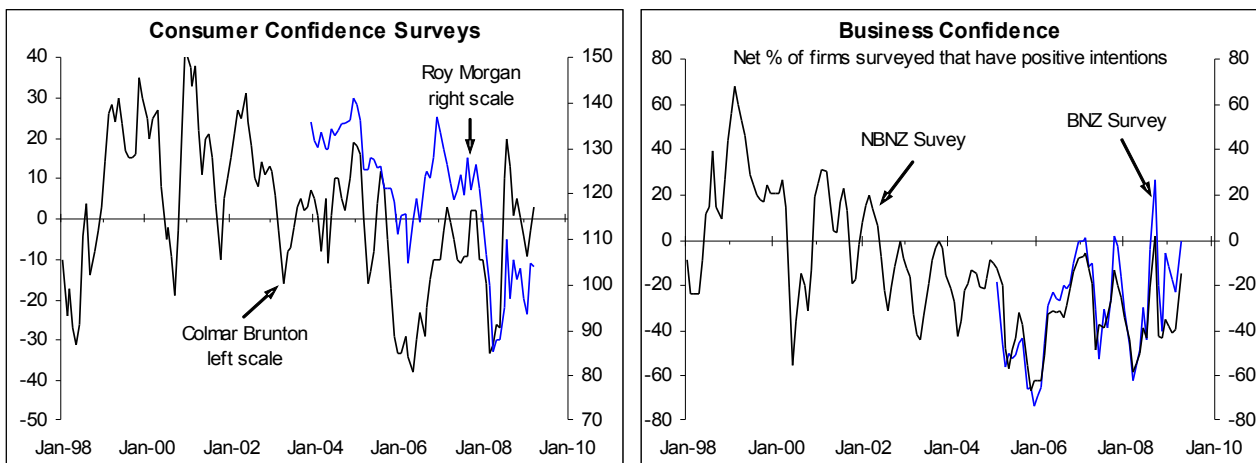




The bottom right chart on the previous page shows the relationship between consumer confidence and annual employment growth. While the relationship between employment growth and the NBNZ survey of employment intentions survey has broken down the relationship between consumer confidence and employment growth remains about as good as ever (i.e. pretty good but not perfect).

The view of many economists has been that a Tsunami is heading the way of NZ consumers (i.e. firms will layoff lots of staff resulting in consumer confidence and consumer spending getting cut off at the knees). But this overlooks the massive interest rate stimulus that is starting to bare fruit. As covered in our **Housing Prospects** reports a strong upturn in house sales is underway that will end the downside in house prices and could even result in house prices increasing in some parts of the country and/or in some pockets of the market. While as covered in our **Building Barometer** reports there is the prospects of an upturn in residential building activity much earlier and stronger than the economists are predicting.

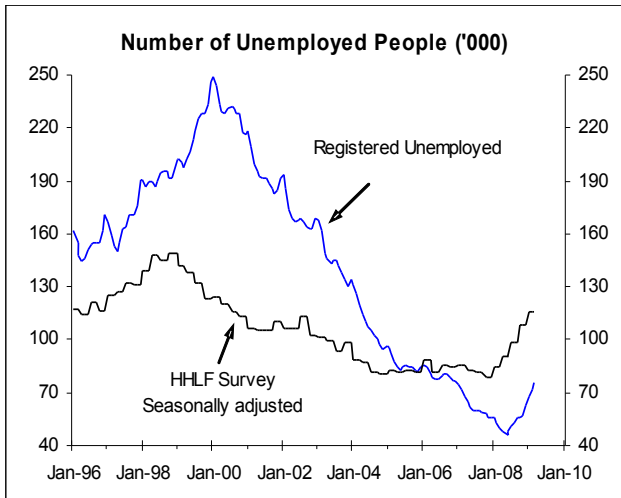
The left chart shows that consumer confidence surveys aren't beaming but instead of them being dragged down to the recessionary lows recently experienced by business confidence surveys the business surveys are starting to recover (see the right chart below). After falling 1% in the March quarter the number of people employed will probably fall again in the June quarter and the unemployment rate is likely to increase further and could peak at around 6% or so this year, but the Tsunami view of economic growth prospects that has been promoted by a number of economists is starting to look past its use-by-date.



But why haven't firms acted on their negative employment intentions? Going into the recession some firms were significantly understaffed. So while there have been a large number of layoffs and these have got the normal frenzy of media attention (see <http://www.stuff.co.nz/business/industries/2001904/Black-day-for-jobs> for example) some firms have continued to employ new staff. Desires to avoid redundancy costs and not to lose core competencies will have played a part. A conspiracy theory is that some firms have been ticking the negative box in the employment intentions survey as a means of getting the RBNZ to cut interest rates more and there is likely to be something in this. The excessive negative responses to the NBNZ survey could mean that a disproportionate number of the National Bank's clients are losers, but this seems unlikely while it is more likely that a number of them are astute and see the survey as a means of manipulating the media and the RBNZ. Another perspective is that even in recessions there are success stories and firms expanding employment, while the media are more inclined to report the negative than the positive stories.

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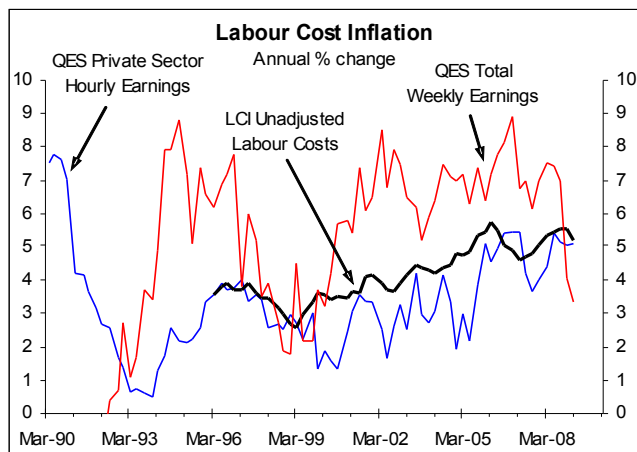
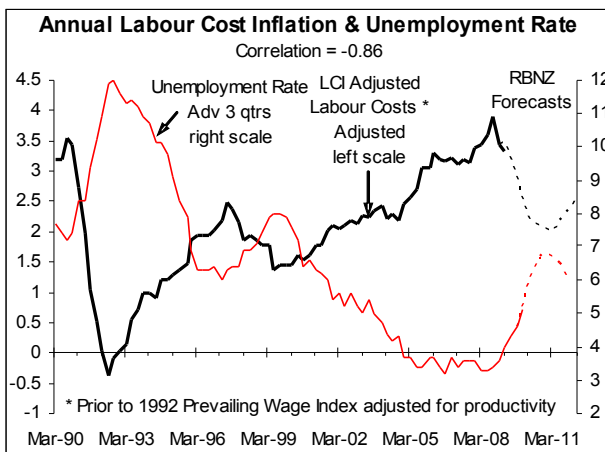


The official unemployment rate comes from the HHLF survey conducted quarterly by SNZ. The survey is based on internationally accepted methodology but like any survey it has a margin of error so the actual unemployment rate could be higher than the 5% reported for the March quarter. Based on the HHLF survey there were 115,000 unemployed people in the March quarter (the black line in the chart which is seasonally adjusted). Another measure of unemployment is the number of people registered for unemployment benefits with WINZ with this figure standing at 75,863 in March (the blue line). We haven't delved into the reasons for the difference between the two measures but both have increased by similar amounts during the recession which gives more credence to what the HHLF measure says.

It is unlikely that we have seen the end of the increase in the unemployment rate but because we believe economic growth prospects this year are better than predicted by most economists – as justified in the monthly **Interesting Times** reports and touched on in some recent Ravings - we don't expect the unemployment rate to surge to the dizzy highs seen in the early 1990s. **Equally, because we are more positive on economic growth prospects than most economists we believe the unemployment rate could be falling again earlier than predicted by the RBNZ and the consensus view of the economic forecasters (see the top charts on page 2).**

### Some implications of our less negative view on the unemployment rate

The left chart below shows the RBNZ's forecasts for the unemployment rate (the dashed red line) and what this implies for the RBNZ's preferred measure of annual labour cost inflation (the dashed black line). The red unemployment rate line has been advanced or shifted to the right by three quarters as a leading indicator of labour cost inflation. The right chart shows a selection of other measures of annual labour cost inflation which are generally running higher than the measure in the left chart because the latter is designed to pick up only the inflation component of labour cost inflation not the component justified by productivity growth (i.e. it picks up only the bad component).



The consensus view of the 10 economic forecasters surveyed by NZIER in March was that private sector hourly earnings would increase by 3.1% in the 2009/10 March year and only 2.3% in the 2010/11 March year. By comparison they are predicting that consumer prices increase 2.3% in 2009/10 and 1.8% in 2010/11. With hourly earnings predicted to increase only moderately more than prices it doesn't leave much fat left over to fund growth in the volume of consumer spending. The upshot is that the economists predict that the volume of consumer spending increases only 0.1% in 2009/10 and 1.4% in 2010/11. This is an example of a loop of dubious logic the economists often get caught in.

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How have the economists arrived at these predictions? Largely by assuming that economic growth will be weak meaning that the unemployment rate must increase because a rising unemployment rate is needed to ensure that income growth will be weak, and weak income growth is needed to ensure that consumer spending growth and overall economic growth will be weak. Of course the missing link in the economists' predictions is the massive stimulus currently at work locally and globally.

If we see a robust upturn in housing market activity that seems likely on the back of the humungous cut in interest rates and this filters to the wide range of industries that service the housing market then economic growth will turn out better than predicted by the economists. Especially as it looks like it will be helped by higher net migration. And if economic growth turns out to be stronger then employment growth will be stronger, income growth will be higher, consumer spending growth will be stronger and economic growth will be stronger. If we assume the outcome we want, which is what economic forecasting is really about based on what I have seen over the last 29 years, we can justify whatever outcome our heart desires.

Most importantly we have faith that the RBNZ will be successful in its mission to underwrite a robust recovery in economic growth, although uncertainties remain over the timing of the recovery. By definition/assumption this means economic growth will be surprisingly strong even if the economists, like usual, don't have faith the mega interest rate cuts, a lower exchange rate and stronger net migration will underwrite a robust upturn in economic growth. Of course, if rabid pigs start falling from the sky then all bets are off. But the economists aren't relying on left-field events like swine flu to justify their dim view of economic growth prospects over the next two years, they are relying on their normal conservatism and a belief that the financial crisis will hang over the NZ economy like a plague even though the NZ banking system is fundamentally sound. We also have more faith than most economists that the NZ credit crunch will end this year or at least that the credit crunch will abate enough for the economy to start growing again this year.

However, every silver lining has a dark cloud attached. We believe there are good reasons to expect the unemployment rate to increase much less than the doomsayers' are predicting (and we put the OECD forecasters in this camp), and by less than most economists are predicting. And this leads us to expect consumer spending and economic growth to be stronger than the consensus view of economists this year and in 2010. But if the unemployment rate increases less it means there will be less headroom for above average economic growth in the future.

The higher the unemployment rate is the longer the RBNZ will be able to be growth-friendly. If the unemployment rate doesn't increase much above 6% on a seasonally adjusted basis, which is our best guess, then it won't take much above average economic growth to drive the unemployment rate down to levels that reawaken the inflationary component of labour cost increases (see the bottom left chart on the previous page). The starting point for the period of above average economic growth between 2000 and 2006 was an unemployment rate of 7.6% (i.e. quite a bit of headroom) while the starting point for the previous period of above average economic growth between 1993 and 1997 was an unemployment rate of almost 11% (i.e. lots of headroom). Even if the unemployment rate reaches the peak level of 6.8% the RBNZ is predicting for the 2010 March quarter it will represent a less favourable starting point than existing prior to the past two periods of strong economic growth.

So while we are more optimistic about economic growth prospects for 2009 and 2010 than the consensus view of economists we question whether the RBNZ will be able to allow the economy to grow as strongly over the next five years as the 3.7% average rate experienced over 2002-06. This means that OCR hikes are likely to be on the agenda earlier than the Governor signalled on 30 April.