Sporadic

7 February 2018

The Necessity of Higher Wages

Today we have seen the release of lots of data on the Labour market from the Household Labour Force Survey, Quarterly Employment Survey and Labour Cost Index. Most commentary you will see will be about the strength of the numbers yet the continuing absence of any decent acceleration in the pace of wages growth. We'll have a look at the main numbers soon.

But the number which I find most interesting regarding our labour market appeared a couple of weeks back in the NZIER's Quarterly Survey of Business Opinion. This survey has been running since the 1960s and provides a good three-monthly summary of how the non-farm business sector is feeling and what they are planning.

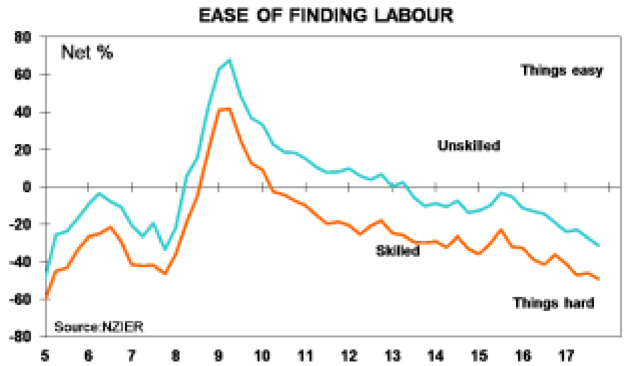
The number which attracted my attention was the net 5% of businesses saying they expect staff turnover (churn) to rise. This sounds like a low outcome. But it is above the net 5% usually saying they feel staff turnover will fall, and is the highest reading since 1994.

Not only that, a net 17% of businesses said labour churn was in fact higher during the most recent quarter which is well above the -2% average and the highest actual outcome since early-2005 when things were humming along.

Employers know what is coming. After years of staff being fearful of asking for more wages because of worries about the world economy, and perhaps more recently being worried about stories of robots and AI taking over, expectations of increased remuneration are rising.

Normally we would fully expect this to result (have already resulted) in a decent acceleration in wages growth. And every expectation we have had of that since 2010 has been wrong here and overseas. Only now in the United States is evidence emerging of decent wages growth. In Australia wages growth is still slowing down.

Will wages growth accelerate rapidly here in NZ now that practically all the measures we look at (and note below) show tight labour supply? Almost certainly not for a number of reasons.



One is that some uncertainty about the developments around them and how they will affect employment undoubtedly still occupy the minds of many people. Another is that the proportion of the workforce which is unionised now sits close to 15% from near 40% in 1990 so collective action as a means of extracting higher wages will probably not amount to much.

A third reason may be that many young people in their early working years could be planning to gain remuneration increases not through staying in the same or similar position or organisation and letting higher ups know of their income expectations, but through moving somewhere else. The world is filled with stories of start-up companies selling for huge prices, and much of business growth these days comes not from strictly in-house developments but the cross-breeding of technologies and ideas gained from outside sources.

Perhaps young people know that building a diverse range of knowledge across a number of firms puts them in a good position to slot into an important role or development further down the track and that is when they will see higher incomes – perhaps in a company they set up. Maybe.

There is however a fourth very important reason why anyone expecting a strong surge in wages growth will be disappointed and why I have chosen to highlight the rising proportion of firms expecting staff to leave. Businesses know what is happening and what is coming. Many firms simply cannot afford to pay higher wages because their ability to recoup higher expenses through raising selling prices has plummeted.

The pace with which the business scene is changing is the fastest we have ever seen. Businesses need to spend more time and effort keeping up with and perhaps developing new products, distribution methods, advertising approaches and so on.

Frequent up to date knowledge and analysis of market conditions is required in a world where consumers have become used to buying online, discounting of stock, and are more willing to desert trusted brands and retailers than ever before.

So as the labour market has tightened and as it will tighten further employees should not expect their bosses to simply front up with much higher wage offers. And the bosses don't expect much of such fronting up either as they have become used to a cowered workforce.

So, as we encouraged people to do with our housing market analysis these past few years, the need now is not to wring our hands about who is in a worse position – staff or crunched business owners - and what "should" happen. When doing economic analysis we need to ask what "will" probably happen?

Three main things are coming. One is further increasing of staff turnover. Employees will realise that in many instances the best way to earn more money is to change employer. More have been doing so recently and a lot more are about to. This will raise cost bases for businesses through recruitment and training costs for replacement staff.

The second thing to happen will be that with the assistance of rising minimum wages there will be some acceleration in the average pace of wages growth. Employers who resist will lose staff.

Some businesses are about to close down because of lack of staff or lack of profit and this will be a very good thing for the economy.

Economic growth and development requires the continual shifting of resources such as land, capital, people, and technology to optimally profitable activities. That process has been retarded in recent years and some firms have remained in business with compliant underpaid staff when it would have been better for the economy if they had closed their doors and staff then went to work elsewhere – perhaps taking their knowledge of new technologies and applying it usefully in their new workplace.

The lack of sufficient "creative destruction" in recent years may help explain the low rates of productivity growth around the world.

The third thing to happen is likely to be what appears to be happening finally in the United States. Businesses are getting off their hands and their balance sheet cash nest eggs and starting to boost their capital spending. New Zealand businesses unable to find staff or unable to afford more or unable to raise prices on existing products to maintain margins will need to spend more.

For some this may mean new or more suitable premises, better computer systems, greater mechanisation. One option for many will need to be better collaboration with other businesses. People will need to think less and less of their own business as a standalone entity linked to other businesses only through supply or sale contracts, but as one node in an information network of many businesses. Businesses unable to manage such collaborations and partnerships successfully will have an increasing problem in the modern fast changing business environment.

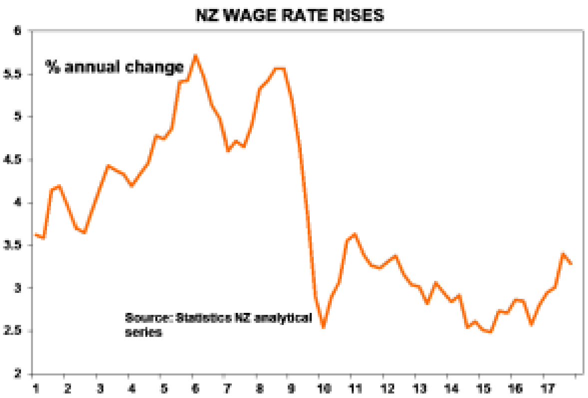
So what is coming for NZ in simple terms is this. The excess of labour demand over labour supply will cause wages growth to accelerate but not by a lot. This rise in wage costs will cause low profit businesses with limited pricing power to close down. Businesses who resist will lose staff and also close down. Valuable labour resource will end up reallocated to more profitable ventures where employers can afford to pay more. The pace of economic growth and remuneration growth will be boosted.

This won't happen in a quarter or a year but will stretch over a number of years and it will be a very positive development for the economy and living standards in New Zealand.

In other words our message to businesses is this – pay up. If you can't then close down quickly so your staff, your buildings, your technologies, your remaining capital, can be put to more useful purposes. Or invest more.

And so to the data which came out today. Job numbers rose by a firm 0.5% in the December quarter after jumping 2.2% in the September quarter and sit 3.7% up from a year earlier. An extra 465,000 people are now employed compared with the low point in the labour cycle in 2009. Almost 50% of those extra jobs are in Auckland. Auckland accounts for just over 34% of NZ's population.

The wages measure which we follow, derived from the Labour Cost Index and tracking an unchanging mix of jobs, rose by 0.9% during the December quarter. This made for a 3.3% gain from a year ago compared with 3.4% in September and 2.8% a year earlier. Wages growth has picked up but the pace is still fairly slow by historic standards.



Just quickly on some other matters

Sharemarket

Share prices have soared over the past year assisted by high expectations of faster growth in the United States from President Trump's fiscal loosening and hopes that businesses will start boosting capital spending. Both things are happening and while the fiscal blowout will eventually have interest rate implications long-term it is extremely unlikely that the correction in exuberant share prices which we are seeing will cause businesses to cease their hunt for scarce employees or cut back on investment plans – sitting as many are on large piles of cash and strong balance sheets built up since 2010.

Thus the markets are likely to soon settle down and for investors who continue to focus on the long-term such daily and weekly perturbations are really quite meaningless – just compare share indexes now with levels of 2009 when the "green shoots" of growth had yet to appear. The correction we are seeing currently is not a reflection of any drastic alteration in the outlook for economic or business profit growth and the trigger of rising inflation and interest rate expectations does not represent any radical change in views.

NZ Dollar

Fundamentally our currency is very well supported by good government and external accounts, strong commodity prices including newly rising dairy prices, strong tourism sector growth, economic strength from construction, migration, technology, infrastructure etc., and political stability. Exporters should look upon periods when the NZD falls three or so cents as opportunities to get some extra hedging in place. This is exactly the same view as we expressed through last year. Personally I believe the long-term trend for the NZD is upward, not downward, and perhaps in a future Sporadic issue we will examine the discrimination we almost all show against any view that our currency will trend up instead of down.

Interest Rates

Chances are that in light of the recent lower than expected inflation in NZ, the strength in the currency, only mild acceleration in wages growth and generally easing housing markets we will not see our central bank raising interest rates until the first half of next year. Before then fixed rates will creep higher because of higher medium to long-term interest rates in the United States. This suggests to me that if I were a borrower I would still be quite happy to continue doing what I would have been doing most of last year – having a spread of fixed rates out to three years maximum and a tad debt floating to allow for cost-free early repayment.

Our floating rate is 5.9%, one year fixed 4.59%, two year fixed 4.65%, and three year fixed 4.99%. Jumping to four years fixed at 5.89% is not an expense I could justify to myself.

Immigration Policy

It looks more and more like this Labour government is as we suspected quite different from earlier versions. Looking through the distraction of the greatest cult of personality since Rob Muldoon's days, they do appear to be listening to the concerns of the business sector and one area in particular appears to reflect this listening – migration policy. Since election day there has been no repeating by NZ First of their desire for a net immigration inflow of only 10,000 people and no mention from Labour of cutting gross inflows by 30,000.

Businesses have made clear to the government their dependence upon immigrant labour and the wider economic impact should they be unable to source labour. The easiest thing for a left-wing government to do would be to ignore these concerns and tighten migration rules whilst encouraging faster wages growth. And if this were the old days this would happen, businesses would jack up their selling prices, consumers would shrug their shoulders and pay up (think insurance, electricity, local authority rates), inflation would rise, the Reserve Bank would raise interest rates, the currency would soar, exporters would flounder, and eventually the whole economy would enter recession and lives would be destroyed.

But what point is there starting such a chain this time around when the wages link no longer works the same, the economy is practically at full employment anyway, and few but the dumbest politicians would be ignorant of the linkages just mentioned and the historical outcome?

So far so good in other words and eventually the downwardly biased business sentiment measures will start to reflect this lack of an outright attack alah the 1999 Government.

For now I would suggest to any businessperson thinking this is an old style Labour government and that sitting on one's hands complaining about things is best – you'd better stand up fairly quickly because your blind spot will be thinking every other business – domestic and international – is also pulling a sad like you. NZ businesses need to recognise the economic outlook is good (consumer confidence is way above average), the world economy is improving, many sectors are thriving, and the government has a door open to the business sector. Get on and invest – especially in labour-saving technology because much as the government may be pulling back from plans to slash immigration, they are not going to open the floodgates to let in staff simply so your wages bill does not go up. That would be a pointless self-serving angle from which to lobby the government for better migrant inflows and you'll be rightly shown the door.

Sporadic is written by Tony Alexander, Chief Economist at the Bank of New Zealand. The views expressed are my own and do not purport to represent the views of the BNZ. Please sign up at www.tonyalexander.co.nz
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