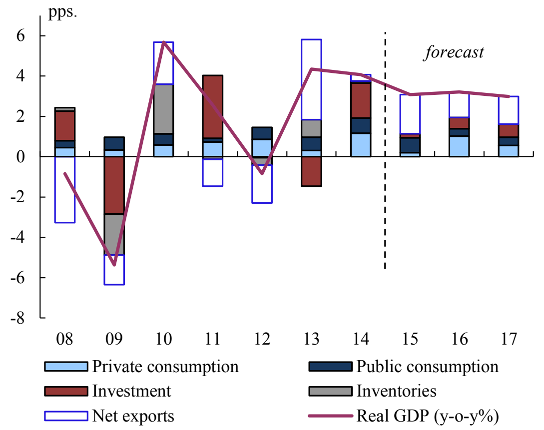
16. LUXEMBOURG

From buoyant to balanced growth

Luxembourg's economic output increased by 4.1% last year, but it is expected to ease to 3.1 % this year and pick up slightly to 3.2% in 2016. While growth currently is being supported by strong net exports associated with the dynamic financial sector, a more balanced composition is projected for the coming years. As robust job creation mostly favours non-resident workers, the unemployment rate is expected to decline only marginally in 2015 and 2016. In spite of a drop in VAT revenues, public finances are projected to remain in balance.

In the first half of 2015, real GDP grew on average by 4.2 % (y-o-y), as low oil prices, favourable financial conditions and exchange rate depreciation provided tailwinds to private consumption and investment. Public consumption and exports of service, mostly financial, expanded at a rapid pace, while improving terms of trade limited import growth to some extent.

Graph II.16.1: **Luxembourg - Real GDP growth and contributions**



Overall performance of the financial sector progressed

The contribution to growth of the financial sector, traditionally Luxembourg's main growth engine, furthered strengthened. After its adjustment to new regulatory financial standards, profitability recovered, although not equally across the sector. While the investment fund industry gained momentum, improvements in the more traditional banking sector were limited by the low interest rate environment, which also affected the insurance sector, especially the life insurers. The economy as a whole benefitted from this renewed strength of the financial sector.

Looking forward, the recent turbulence in financial markets and less favourable prospects for growth in emerging economies are expected to slow down the pace of economic expansion, starting already in the second half of this year. Overall, GDP is forecast to increase by a still healthy 3.1% in 2015. In 2016 and 2017, under the assumption of a less supportive external environment but a slightly more robust domestic demand, output growth will remain stable around 3%.

Growth supported by all components

Anticipation effects at the end of last year, related to the legislated increase in VAT rates dampened private consumption at the beginning of 2015. Positive employment prospects and low price pressures are expected to support household purchasing power and private consumption in 2015. This holds also in 2016 when wage indexation should offset a less dynamic labour market.

Investment, mostly in construction, is projected to remain robust over the forecast period, supported by the execution of large public infrastructure projects. By contrast, in spite of accommodative credit conditions, equipment investment is expected to remain subdued, as capacity utilisation remains low.

The contribution of net exports to growth is expected to be strong in 2015. As global economic conditions gradually become less favourable, domestic demand and net exports will make similar contributions to growth in the outer years of the forecast horizon.

Job creation remains high

Employment growth accelerated to 2.6% in the first part of the year from 2.5% in 2014, with job creation being dynamic in all economic sectors, and it is set to decline to 2.3% in 2017. The unemployment rate is expected to decline to 5.9% in 2015 and only to 5.8% in 2016 as non-residents are likely to benefit more from the new jobs.

Inflation set to remain low, in spite of the increase in VAT rates

Headline inflation is projected to further slow to 0.3% in 2015, from 0.7% in 2014, driven by lower oil and other commodity prices, meaning that automatic wage indexation will only be triggered in the first quarter of 2016. The impact of the planned rise in VAT rates is visible, however, in core inflation, which is expected to increase to 2.0% in 2015 after 1.6% in the previous year. In 2016 and 2017, inflation is projected to bounce back, supported by the quantitative easing programme of the ECB and the gradual recovery of oil prices.

The government balance weakens in 2015

The general government surplus is expected to fall from 1.4% of GDP in 2014 to a balanced budget in 2015, mostly because of an expected fall in VAT revenues from e-commerce estimated at around 1½% of GDP that will be only partially compensated by revenue raising measures in the budget of around ½% of GDP. Moreover, higher-than-expected revenues from the subscription tax levied on net assets of investment funds will only partially compensate for a shortfall in revenues from excises on fuel and tobacco. On the expenditure side, in line with a surge in public investment, intermediate consumption is projected to increase at a faster pace. Apart from costs related to Luxembourg's EU Presidency, the public wage bill is also being driven up by the implementation of a public-sector wide agreement.

The incremental effect of measures adopted with the 2015 budget should further strengthen government finances and lead to a larger surplus in 2016 and 2017, even if in the latter year improvements will be limited given that Luxembourg's share of e-VAT revenues will be further reduced from 30% to 15%.

The surplus of the government's structural balance is expected to narrow by 1½% of GDP in 2015 and to slightly improve in 2016 and to stabilise at that level in 2017.

The debt-to-GDP ratio is set to slightly increase from 23% in 2014 to 23.5% at the end of the forecast horizon.

Table II.16.1:

Main features of country forecast - LUXEMBOURG

	2014			Annual percentage change						
	mio EUR	**Curr. prices**	**% GDP**	**96-11**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
GDP		48897.5	100.0	3.8	-0.8	4.3	4.1	**3.1**	**3.2**	**3.0**
Private Consumption		15263.9	31.2	2.8	2.7	0.9	3.7	**0.7**	**3.3**	**1.8**
Public Consumption		8345.0	17.1	3.7	3.6	3.9	4.5	**4.3**	**2.1**	**2.3**
Gross fixed capital formation		9092.7	18.6	5.0	-0.3	-7.2	9.9	**1.1**	**3.0**	**3.5**
of which: equipment		3629.9	7.4	6.5	23.6	-14.7	18.3	**-4.2**	**1.0**	**3.5**
Exports (goods and services)		99393.0	203.3	6.6	0.2	6.9	6.8	**4.9**	**4.6**	**4.8**
Imports (goods and services)		83555.9	170.9	7.1	1.5	5.7	8.0	**4.7**	**4.7**	**4.9**
GNI (GDP deflator)		32726.6	66.9	2.5	-0.9	-1.7	5.9	**-0.8**	**3.1**	**2.7**
Contribution to GDP growth:	Domestic demand			2.7	1.4	-0.5	3.7	**1.1**	**1.9**	**1.6**
	Inventories			0.1	-0.4	0.9	0.1	**0.0**	**0.0**	**0.0**
	Net exports			1.0	-1.9	4.0	0.3	**1.9**	**1.3**	**1.4**
Employment				3.4	2.4	1.8	2.5	**2.6**	**2.5**	**2.3**
Unemployment rate (a)				3.7	5.1	5.9	6.0	**5.9**	**5.8**	**5.8**
Compensation of employees / head				3.0	1.6	3.6	2.9	**1.0**	**2.6**	**2.2**
Unit labour costs whole economy				2.7	4.9	1.2	1.4	**0.5**	**1.9**	**1.5**
Real unit labour cost				0.2	0.8	-1.2	0.4	**0.8**	**0.3**	**-0.5**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.4	4.1	2.4	1.0	**-0.2**	**1.6**	**2.0**
Harmonised index of consumer prices				2.4	2.9	1.7	0.7	**0.3**	**1.7**	**1.7**
Terms of trade of goods				0.1	0.1	0.1	0.6	**-0.2**	**-0.2**	**0.5**
Trade balance (goods) (c)				-7.9	-3.6	-0.7	-0.6	**-1.6**	**-1.6**	**-1.5**
Current-account balance (c)				9.2	6.1	5.7	5.5	**4.3**	**4.0**	**3.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	5.2	4.0	3.5	**4.4**	**4.2**	**3.9**
General government balance (c)				2.1	0.2	0.7	1.4	**0.0**	**0.5**	**0.5**
Cyclically-adjusted budget balance (d)				1.9	2.5	2.1	2.3	**0.7**	**0.9**	**0.9**
Structural budget balance (d)				-	2.5	2.1	2.1	**0.7**	**0.9**	**0.9**
General government gross debt (c)				9.4	22.1	23.4	23.0	**22.3**	**23.9**	**23.5**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.