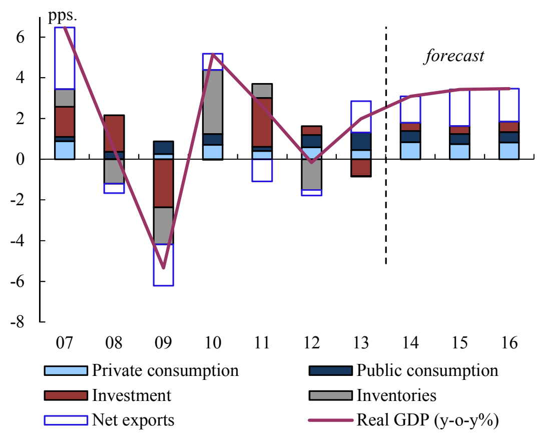
16. LUXEMBOURG

Growth heading towards pre-crisis levels

Luxembourg's economy is projected to grow by 3.4% this year and further accelerate to 3.5% next year. Growth is expected to be balanced, with almost equal contribution from domestic demand and net export. In line with robust job creation, the unemployment rate is projected to decline while inflation will remain subdued despite a rise in VAT rates. Public finances are projected to remain in balance, despite the drop in VAT revenues, linked to a change in EU legislation related to e-commerce.

Real GDP growth averaged 3.1% in 2014 after having accelerated well above 3% in annual terms in the second part of the year, compared to 1.9% in the first six months. It is, however, worthwhile to note that anticipation effects associated with the VAT rates increase taking effect in January 2015 could have played a role and boosted household consumption and investment at the end of the year. All demand components provided a positive contribution.

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



Successful transition of the financial sector

Looking forward, soft and hard indicators signal a firming recovery. Luxembourg is well positioned to benefit from favourable changes underway in the external economic environment. The profitability of the country's main growth engine, the financial sector, suffered in recent years due to the adjustment to new regulatory financial standards but this transition can be considered now as almost completed. At the same time, the investment fund industry is gaining momentum, also boosted by the ECB's non-conventional monetary policy measures. Against this background and in light of the expected improvement in the external economic environment, output growth is expected to pick up to 3.4% in 2015 and to accelerate marginally to 3.5% in 2016.

On the demand side, lower oil prices and positive employment prospects will continue to support household purchasing power and private consumption. However, consolidation measures in the 2015 budget, including a 2 pps. increase in VAT rates, act in the opposite direction, temporarily dampening household spending growth. As the economy picks up and the effect of the VAT hike fades, private consumption is projected to accelerate in 2016. As capacity utilisation remains low, the gradually improving external environment and the Investment Plan for Europe, combined with more accommodative credit conditions, are likely to provide only a mild boost to investment growth in 2015, although an acceleration is projected in 2016. Public investment, by contrast, is expected to surge by more than 10% this year, mainly due to the execution of large infrastructure projects.

The contribution of net exports to growth is expected to remain highly positive in 2015, backed by the sustained performance of services and despite the acceleration of imports. As global economic conditions gradually improve, external trade should gather further strength in 2016.

In 2014, employment increased by 2.4%. Labour creation was buoyant in most sectors, and growth of frontier workers returned to outpace that of residents. Overall, labour market prospects are projected to remain positive, with employment growth set to average around 2½% per year over the forecast horizon, driven by the solid economic outlook. The unemployment rate is expected to start declining already in 2015 and to further drop in 2016, reflecting the dynamism of economic activity.

Looking for a stable regulatory environment

The main risk relates to the financial sector's capacity to protect its comparative advantages amid risks of significant shifts in the regulatory environment.

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

In 2014, inflation averaged just 0.7%. In December headline inflation dipped below zero for the first time in several years and remained negative in the first quarter of this year. Overall, in 2015 it is expected that the sharp fall in oil prices will offset the impact of the legislated rise in VAT rates, leading to an annual HICP inflation rate of 0.8%. Inflation, however, should bounce back to 2.1% in 2016, in line with sustained demand and also boosted by the quantitative easing programme of the ECB.

The government balance weakens in 2015

In 2014, the general government surplus came in at 0.6% of GDP compared to 0.9% in 2013. In 2015, the general government balance is expected to further weaken, mostly due to a change in EU legislation on e-commerce services. According to the new rules, VAT on sales of e-commerce services will accrue to the country where the consumer is located and not any longer to the country where the supplier is established. This will entail for the government a drop in VAT revenues estimated at around 1½% of GDP.

The implementation of measures in the most recent consolidation package, including the hike of all VAT rates by 2 pps., the new 'impôt d'équilibrage budgétaire temporaire' levied on personal income and the implementation of measures from the expenditure review will improve the government's accounts by around 1.0% of GDP, therefore substantially, but not fully, compensating for the loss. Nevertheless, the upward revision of the macro-economic scenario is expected to boost fiscal revenues while low inflation will help in containing expenditure. All in all, the headline balance in 2015 is projected to turn into a balanced budget. This also factors in a sharp increase of public investment in infrastructure projects.

In 2016, the incremental effect of measures adopted with the 2015 budget should further strengthen government's finances and lead to a small surplus. The surplus of the government's structural balance is expected to narrow by 1% of GDP in 2015 and broadly stabilise in 2016.

In spite of a regular primary surplus, the debt-to-GDP ratio is set to increase to 25.3% of GDP over the forecast horizon, mirroring developments in the deficit of the central government.

Table II.16.1:

Main features of country forecast - LUXEMBOURG

	2013			Annual percentage change						
mio EUR	Curr. prices	% GDP	95-10	2011	2012	2013	2014	2015	2016
GDP	45288.1	100.0	3.7	2.6	-0.2	2.0	**3.1**	**3.4**	**3.5**
Private Consumption	14067.3	31.1	2.7	1.2	1.9	1.5	**2.7**	**2.4**	**2.7**
Public Consumption	7826.4	17.3	3.9	1.2	3.7	5.0	**3.2**	**2.9**	**2.9**
Gross fixed capital formation	7725.5	17.1	3.3	14.4	2.4	-4.5	**2.4**	**2.4**	**3.0**
of which: equipment	3123.6	6.9	4.1	23.9	19.4	-7.1	**2.3**	**-0.5**	**3.1**
Exports (goods and services)	92080.4	203.3	6.5	5.0	2.9	5.6	**2.4**	**4.4**	**5.3**
Imports (goods and services)	76137.6	168.1	6.7	6.9	3.8	5.8	**2.1**	**4.3**	**5.5**
GNI (GDP deflator)	28763.1	63.5	2.6	3.0	-1.5	0.1	**1.6**	**2.7**	**3.7**
Contribution to GDP growth:	Domestic demand		2.4	3.0	1.6	0.5	**1.8**	**1.6**	**1.8**
	Inventories		0.1	0.7	-1.5	0.0	**0.0**	**0.0**	**0.0**
	Net exports		1.2	-1.1	-0.3	1.5	**1.3**	**1.8**	**1.6**
Employment			3.4	2.9	2.4	2.0	**2.4**	**2.5**	**2.3**
Unemployment rate (a)			3.6	4.8	5.1	5.9	**5.9**	**5.7**	**5.4**
Compensation of employees / head			2.9	2.1	1.5	3.6	**2.3**	**1.7**	**2.3**
Unit labour costs whole economy			2.7	2.4	4.2	3.6	1.6	0.8	1.2
Real unit labour cost			0.3	-2.4	0.7	2.2	**0.7**	**0.6**	**-0.5**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			2.3	5.0	3.5	1.4	**0.9**	**0.2**	**1.7**
Harmonised index of consumer prices			-	3.7	2.9	1.7	**0.7**	**0.8**	**2.1**
Terms of trade of goods			0.0	2.5	-1.3	-0.2	**-0.5**	**-0.3**	**0.0**
Trade balance (goods) (c)			-7.9	0.4	2.0	5.0	**4.9**	**5.1**	**4.9**
Current-account balance (c)			9.6	5.8	5.7	4.9	**5.3**	**4.6**	**4.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			-	5.4	4.8	3.4	**5.4**	**4.8**	**4.9**
General government balance (c)			2.2	0.4	0.1	0.9	**0.6**	**0.0**	**0.3**
Cyclically-adjusted budget balance (d)			2.0	1.0	1.8	2.5	**1.8**	**0.6**	**0.4**
Structural budget balance (d)			-	1.0	1.8	2.5	**1.6**	**0.6**	**0.4**
General government gross debt (c)			8.7	19.1	21.9	24.0	**23.6**	**24.9**	**25.3**

(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.