16. LUXEMBOURG

Rising domestic demand drives growth

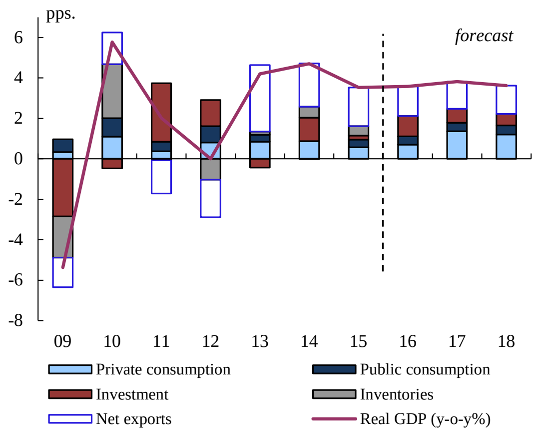
Economic activity in Luxembourg is expected to grow by 3.6% in 2016 and then to pick up to 3.8 % in 2017 before returning to 3.6% in 2018. Growth looks set to be driven by strong domestic demand, with additional support from the external sector. Unemployment is expected to decline as job creation continues to be dynamic, while inflation should increase progressively. In spite of a substantial fiscal stimulus, public finances are projected to remain in balance.

Sustained growth in 2016

Economic activity in Luxembourg is projected to increase at a sustained pace of 3.6% in 2016, with both domestic demand and net exports contributing substantially to growth.

Private consumption is expected to improve moderately, helped by robust job creation, contained inflation and favourable financial conditions, which will also favour investment that is expected to expand further. In particular, construction, both residential and non-residential, is projected to remain robust though decelerating somewhat, supported by households' and government investment. By contrast, as both capacity utilisation and demand from the euro area remain low and in spite of the accommodative credit stance, the surge in equipment investment is mostly driven by specific sectors, in particular purchases from the aeronautic and satellite industry.

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



The financial sector, traditionally Luxembourg's main growth engine, has regained strength after a sharp drop at the beginning of the year following increased volatility in financial markets. The investment fund industry was in July close to reaching the record high levels of end-2015. Overall, in spite of the high costs that adjusting to the new regulatory standards has entailed, the banking sector maintained its profitability in the first half of the year and credit to the non-financial private sector increased. However, recent data suggest that a deceleration could take place in the second half of the year.

Domestic demand boosting growth

Important policy stimulus marks the outlook for 2017. First, the government has announced a tax reform, including new measures in favour of both households and corporations. Secondly, automatic wage indexation is expected to be triggered by the end of 2016, implying nominal wage increases of 2.5%. These stimuli are likely to spur consumption and investment, but the impact on GDP is expected to be contained given that part of it will be saved and a large share of consumption and investment in Luxembourg is imported. Nonetheless, economic activity should remain buoyant and GDP growth is projected to climb slightly to 3.8% in 2017.

In 2018, consumption is expected to lose some momentum, with income effects fading away and inflation kicking in. Economic growth is expected to be sustained by a recovery in the external environment, especially in the euro area. Overall, growth is projected to ease slightly to 3.6%.

Buoyant job creation

In 2016, employment is expected to rise to 2.8%. Labour market prospects are expected to remain positive, with employment growth set to reach 2.9% in 2017, driven by the economy's strong momentum and 2.6% in 2018. The unemployment rate is estimated at 6.2% in 2016 to then decline marginally to 6.1% in 2017 (6.2% in 2018), not as much as employment figures would suggest due to the high share of non-residents among new workers.

Inflation ready to pick up

HICP inflation is set to remain flat in 2016, mainly due to the low oil prices. However, as energy inflation appears to have bottomed out, and based on the assumed increase in oil prices over the forecast horizon, HICP inflation is projected to increase and reach around 2% in 2018. Core inflation is expected to remain subdued and to accelerate only in 2018, given the lengthy pass-through of low energy prices to other sectors.

Available fiscal space has been used

In 2016, the general government balance is expected to post a surplus of 1.3% of GDP. Low inflation combined with the incremental impact of measures adopted in the 2015 budget should help to contain expenditure, despite a high level of public investment maintained by the authorities. At the same time, revenues are set to remain firm in line with the robust economic growth projected.

The general government surplus is then expected to fall to a balanced budget in 2017, mostly due to the impact of the announced taxation reform that is to take effect at the beginning of the year. In addition to repealing the temporary budgetary levy introduced in 2015, tax brackets are set be revised to become less progressive, while two new tax brackets for high revenues are expected to be introduced. In addition, tax credits related to house purchases are planned to be increased. Moreover, the corporate income tax rate is expected to be reduced to 19% from 21% and a more favourable tax treatment for small enterprises is likely to be introduced. All in all, these tax reforms are expected to shave revenues by an estimated 0.8% of GDP. Finally, due to a change in legislation, the share of VAT revenues held by Luxembourg on e-commerce related transactions will decline to 15% from 30%. Based on a no-policy change assumption, the general government balance is projected to improve slightly in 2018 to a surplus of 0.1% of GDP.

The large structural surplus is then expected to narrow by around 1½ of percentage points of GDP between 2016 and 2018, but to remain in positive territory. Luxembourg debt-to-GDP ratio stood at to 22.1% of GDP in 2015. In spite of a regular primary surplus, it is set to increase to 23.5 % of GDP over the forecast horizon, as the surplus of the social security sector cannot be used to finance the deficit of the central government.

Table II.16.1:

Main features of country forecast - LUXEMBOURG

		2015		Annual percentage change						
		mio EUR Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		51216.2	100.0	3.8	4.2	4.7	3.5	**3.6**	**3.8**	**3.6**
Private Consumption		15702.8	30.7	2.9	2.6	2.7	1.8	**2.3**	**4.6**	**4.1**
Public Consumption		8553.9	16.7	4.0	1.9	0.0	2.3	**3.1**	**2.6**	**2.7**
Gross fixed capital formation		9719.0	19.0	4.9	-2.1	6.0	1.0	**5.3**	**3.6**	**3.0**
of which: equipment		3349.4	6.5	8.1	-6.2	6.1	-12.7	**4.2**	**3.6**	**3.3**
Exports (goods and services)		120658.0	235.6	6.3	6.3	12.1	12.8	**2.7**	**3.9**	**4.3**
Imports (goods and services)		103749.5	202.6	6.6	5.3	13.1	14.0	**2.4**	**3.9**	**4.4**
GNI (GDP deflator)		33335.1	65.1	2.6	0.2	4.4	0.6	**6.5**	**3.8**	**4.1**
Contribution to GDP growth:	Domestic demand			2.7	0.8	2.0	1.1	**2.2**	**2.5**	**2.2**
	Inventories			0.1	0.2	0.5	0.5	**0.0**	**0.0**	**0.0**
	Net exports			1.1	3.3	2.1	1.9	**1.3**	**1.3**	**1.4**
Employment				3.4	1.8	2.6	2.6	**2.8**	**2.9**	**2.6**
Unemployment rate (a)				3.8	5.9	6.0	6.4	**6.2**	**6.1**	**6.2**
Compensation of employees / head				3.0	2.3	2.6	0.9	**0.4**	**2.5**	**1.9**
Unit labour costs whole economy				2.5	0.0	0.5	0.1	**-0.4**	**1.6**	**0.9**
Real unit labour cost				0.2	-1.3	-1.0	-0.3	**-2.3**	**-1.3**	**-1.3**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.3	1.3	1.5	0.4	**1.9**	**2.9**	**2.2**
Harmonised index of consumer prices				2.5	1.7	0.7	0.1	**0.0**	**1.6**	**1.9**
Terms of trade of goods				0.3	-0.9	1.1	2.0	**0.2**	**0.4**	**0.1**
Trade balance (goods) (c)				-6.9	-1.0	1.3	3.4	**3.1**	**2.9**	**3.2**
Current-account balance (c)				8.8	5.6	5.1	5.2	**5.6**	**5.6**	**5.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	3.8	2.9	4.1	**6.1**	**6.1**	**6.4**
General government balance (c)				2.0	1.0	1.5	1.6	**1.3**	**0.0**	**0.1**
Cyclically-adjusted budget balance (d)				1.9	2.6	2.5	2.4	**1.9**	**0.4**	**0.4**
Structural budget balance (d)				-	2.6	2.5	2.2	**1.9**	**0.4**	**0.4**
General government gross debt (c)				10.7	23.5	22.7	22.1	**23.2**	**23.3**	**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.