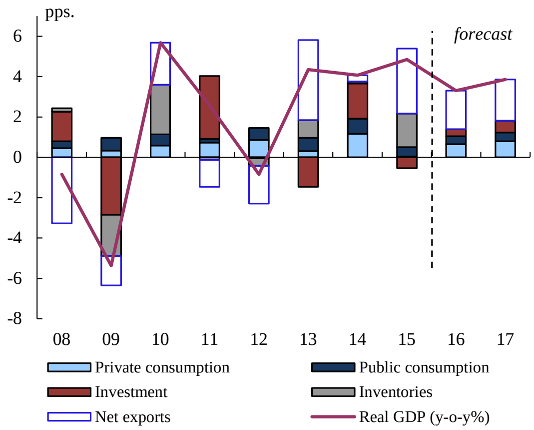
16. LUXEMBOURG
More balanced growth ahead

Luxembourg's economic growth is projected to ease from 4.8% in 2015 to 3.3 % this year and to accelerate to 3.9 % next year. Over this time growth is expected to become more balanced, as domestic demand catches up with the external sector as a leading driver of growth. Unemployment is expected to decline as job creation remains robust, while inflation should remain subdued as a result of low energy prices.The general government surplus is expected to fade in 2017 due to the impact of the tax reform.

Strong growth in 2015

Real GDP growth expanded to 4.8 % in 2015 (from 4.1% in 2014), driven by a sharp improvement in net exports of financial services, especially in the first half of the year. Private consumption picked up in the second half, as spending recovered from a VAT hike in January.

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



Recent trends shape slower growth for 2016

Both soft and hard indicators point to a continuation of the trends observed in the second half of 2015. In 2016, GDP is expected to grow by 3.3%, still driven by a large, though decreasing contribution from external sector. Less favourable financial markets are likely to have a dampening effect on the export-focused financial industry and limit the contribution to growth of net exports. By contrast, the contribution from domestic demand is expected to strengthen. Low oil prices, favourable financial conditions and positive employment prospects should provide tailwinds to private consumption, even if indexed wage increases are now only expected to take place by the beginning of 2017. It is worth noting that buoyant job creation is contributing to population growth by attracting immigration flows. As a result, per capita gains should remain moderate. Steadily favourable lending conditions should support investment. In particular, construction is projected to remain robust over the forecast period, supported both by household and public sector investment plans, the latter being engaged with the execution of large public infrastructure projects. By contrast, in spite of the accommodative credit stance, equipment investment is expected to remain subdued, as capacity utilisation remains low.

In 2017, net export's contribution to growth is expected to remain stable, while domestic demand, and in particular private consumption, should continue to gain momentum, underpinned by strong employment and indexed wage increases which support household purchasing power. Overall Luxembourg's economic growth is forecast to accelerate to 3.9% in 2017.

Buoyant job creation continues

In 2015, employment increased by 2.5%. 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 economy's strong momentum. The unemployment rate was 6.4% in 2015 and is expected to decline to around 6% in 2016, not as much as employment figures would suggest due to the high share of non-residents among new workers.

Inflation pulled down by energy prices

HICP inflation is set to fall to -0.1% in 2016 from 0.1% in 2015, mainly because of the pronounced drop in oil prices, which are expected to remain low for a protracted period, thus postponing the automatic indexation of wages to the beginning of 2017. Core inflation is projected to remain subdued over the forecast horizon, given the lengthy low energy prices are spreading to other sectors and as the impact of the increase in all VAT rates that occurred at the start of 2015 phases out.

The budget surplus is expected to fade out

In 2015, the general government surplus surprised on the up side and came in at 1.2% of GDP. Expenditure was lower than expected, in particular for intermediate consumption, public wages and some local government investment projects were deferred. On the revenue side, the yield from taxes on households and corporate income was higher than anticipated and the loss due to the change in the e-VAT regulation turned out to be lower than expected. By contrast, the yield from government measures to counter the expected loss in e-VAT revenues came in as planned. These included a 2 pps. increase of all VAT rates, the introduction of a temporary budgetary levy and the saving measures in the 'Pact pour l'Avenir'.

In 2016, the low inflation environment together with the incremental effect of measures already adopted in the 2015 budget should help to contain expenditure and counterbalance the impact on the government budget of the projected downward revision of the macroeconomic scenario. All in all, the surplus for this year is estimated at 1.0 % of GDP.

The general government surplus, however, is expected to fall to just 0.1% of GDP in 2017, due to the impact of the recently announced taxation reform that should take effect in that year. Both households and corporations are expected to benefit from the reform, with the former benefitting more. In addition to repealing the temporary budgetary levy introduced in 2015, tax brackets will be revised to become less progressive, while two new tax brackets for high revenues will be introduced. In addition, tax credits related to house acquisition will be increased. Moreover, the corporate income tax rate will be reduced to 19% from 21% and a more favourable tax treatment for small entreprises will be introduced. All in all, the taxation reform is estimated to shave off revenues by around 0.8% of GDP.

The large structural surplus is then expected to narrow by about 1½ pps. of GDP between 2015 and 2017, but to still remain in positive territory. The debt-to-GDP ratio decreased to 21.4% of GDP in 2015. In spite of a regular primary surplus, it is set to increase to 22.8 % of GDP over the forecast horizon, as the social security sector's surplus cannot be used to finance the deficit of the central government.

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	**4.8**	**3.3**	**3.9**
Private Consumption		15263.9	31.2	2.8	2.7	0.9	3.7	**0.1**	**2.2**	**2.8**
Public Consumption		8345.0	17.1	3.7	3.6	3.9	4.5	**2.7**	**2.4**	**2.6**
Gross fixed capital formation		9092.7	18.6	5.0	-0.3	-7.2	9.9	**-2.9**	**1.9**	**3.4**
of which: equipment		3629.9	7.4	6.5	23.6	-14.7	18.3	**-8.7**	**-1.6**	**3.2**
Exports (goods and services)		99393.0	203.3	6.6	0.2	6.9	6.8	**7.0**	**4.3**	**4.9**
Imports (goods and services)		83555.9	170.9	7.1	1.5	5.7	8.0	**6.5**	**4.1**	**4.8**
GNI (GDP deflator)		32726.6	66.9	2.5	-0.9	-1.7	5.9	**3.2**	**1.2**	**1.4**
Contribution to GDP growth:	Domestic demand			2.7	1.4	-0.5	3.7	**0.0**	**1.4**	**1.8**
	Inventories			0.1	-0.4	0.9	0.1	**1.7**	**0.0**	**0.0**
	Net exports			1.0	-1.9	4.0	0.3	**3.2**	**1.9**	**2.1**
Employment				3.4	2.4	1.8	2.5	**2.5**	**2.6**	**2.5**
Unemployment rate (a)				3.7	5.1	5.9	6.0	**6.4**	**6.2**	**6.2**
Compensation of employees / head				3.0	1.6	3.6	2.9	**0.8**	**0.3**	**2.6**
Unit labour costs whole economy				2.7	4.9	1.1	1.4	**-1.4**	**-0.4**	**1.2**
Real unit labour cost				0.2	0.8	-1.2	0.4	**-3.0**	**-1.3**	**-0.7**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.4	4.1	2.4	1.0	**1.6**	**0.9**	**1.9**
Harmonised index of consumer prices				2.4	2.9	1.7	0.7	**0.1**	**-0.1**	**1.8**
Terms of trade of goods				0.1	0.1	0.1	0.6	**3.5**	**0.0**	**0.2**
Trade balance (goods) (c)				-7.9	-3.6	-0.7	-0.6	**0.0**	**0.4**	**1.0**
Current-account balance (c)				9.2	6.1	5.7	5.5	**5.5**	**5.3**	**4.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	5.2	4.0	3.5	**4.4**	**5.8**	**5.3**
General government balance (c)				2.1	0.3	0.8	1.7	**1.2**	**1.0**	**0.1**
Cyclically-adjusted budget balance (d)				1.9	2.7	2.4	3.0	**1.7**	**1.4**	**0.3**
Structural budget balance (d)				-	2.7	2.4	2.8	**1.7**	**1.4**	**0.3**
General government gross debt (c)				9.8	22.0	23.3	22.9	**21.4**	**22.5**	**22.8**

(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.