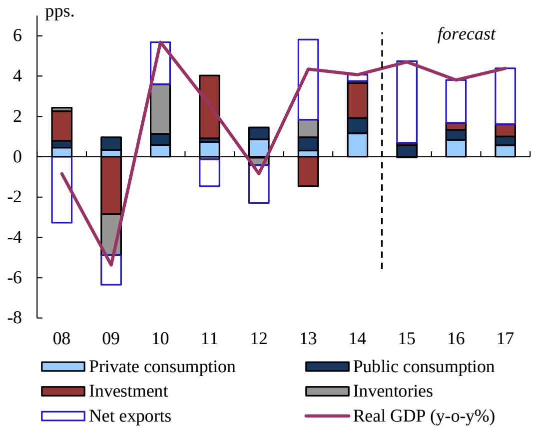
16. LUXEMBOURG

Robust growth ahead

Luxembourg's growth is expected to have accelerated to 4.7% in 2015 from 4.1% in the previous year, mainly due to strong exports of financial and non-financial services. In spite of the VAT rates increase headline inflation remained mute. Employment growth is projected to remain solid, while unemployment is expected to decrease only marginally. Public finances are projected to remain sound.

Real GDP year-on-year growth in the last quarter of 2015 is likely come in weak as a result of base effects, given that the last quarter of 2014 was exceptionally strong due to anticipation effects related to the increase in VAT rates that took place at beginning of 2015. Over 2015 as a whole, however, Luxembourg's economy is expected to have expanded by 4.7%, driven by a sharp improvement in net exports of services and strong growth of 5.7% in the first three quarters of the year.

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



Robust but volatile growth ahead

In 2016, GDP is expected to grow by 3.8% still mostly driven by the large, even if decreasing, contribution from net export. By contrast, the contribution from domestic demand is expected to build up. Low oil prices, favourable financial conditions and positive employment prospects will provide tailwinds to private consumption. Moreover, household purchasing power should also benefit from indexed wage increases, even if these are now only expected to occur in the second half of the year. Favourable lending conditions should boost 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.

Finally, in 2016 volatile financial markets are forecast to limit the contribution to growth of net exports. While import is expected to remain broadly stable, financial market turbulence is projected to have a dampening effect on the export-focused financial industry.

In 2017, the contribution of net export to growth is expected to become more pronounced, while private consumption will contribute less, given a less favourable labour market and increasing price pressures. Overall Luxembourg's economy is forecast to grow by around 4.4% in 2017.

Risks to this scenario are quite balanced

The financial sector will remain the main growth engine and in the near future, the country's economic prospects will hinge on its ability to address all the challenges that the sector is facing.

Job creation remains robust

In 2015, employment growth is expected to have accelerated to 2.6% from 2.5% in 2014. However, this proved to be insufficient to lower the unemployment rate, which increased to 6.1% from 6.0% the previous year. As non-residents are likely to benefit more from declining, but still robust job creation, the unemployment rate is forecast to decrease only marginally by the end of the forecast horizon.

A rebound in inflation has been delayed

Headline HICP inflation fell to 0.1% in 2015, mainly because of the pronounced drop in oil prices. As oil prices are expected to remain low for a protracted period, the projected rebound in inflation is unlikely to occur before 2017. On the basis of these projections, the automatic indexation of wages will be triggered only in the second half on 2016. Core inflation is projected to remain stable just below 2% in 2016 and 2017, better reflecting the impact of the increase in all VAT rates that occurred at the start of 2015.

Small but stable fiscal surplus ahead

In 2015, the sharp drop in VAT revenues from e-commerce, equivalent to around 1¼% of GDP, was only partially counterbalanced by the additional revenues from the new tax levied on personal income and the revenues linked to the 2 pp. increase in VAT rates. Finally, in line with the favourable evolution of the stock markets, revenues from the subscription tax on the net assets of investment funds were higher than originally expected.

On the expenditure side, savings from the non-indexation of social expenditure have been offset by a surge in public investment and associated intermediate consumption costs. Costs related to Luxembourg's EU Presidency and the implementation of a public sector-wide wage agreement have also driven up overall expenditure.

The general government surplus is thus expected to drop from 1.4% in 2014 to 0.2% of GDP in 2015.

In line with the expected incremental impact of measures adopted with the 2015 budget, government finances are projected to improve and lead to a larger surplus in 2016 and 2017, even if in the latter year's improvements will be limited given that Luxembourg's share of e-VAT revenues will be further reduced from 30% to 15% of VAT proceeds related to e-commerce activities.

This forecast does not include any impact from the announced reform of the taxation system set to be implemented at beginning of 2017 given that it is not sufficiently specified yet.

The surplus of the government's structural balance is expected to narrow by about 1¾% of GDP in 2015, still remaining in positive territory and to decline further towards the end of the forecast period as the output gap closes rapidly.

Luxembourg's debt-to-GDP ratio is set to decrease from 23% in 2014 to 21.3% in 2015, to then increase slightly to 22% 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	**4.7**	**3.8**	**4.4**
Private Consumption		15263.9	31.2	2.8	2.7	0.9	3.7	**-0.1**	**2.9**	**2.0**
Public Consumption		8345.0	17.1	3.7	3.6	3.9	4.5	**3.3**	**2.9**	**2.6**
Gross fixed capital formation		9092.7	18.6	5.0	-0.3	-7.2	9.9	**0.7**	**1.9**	**3.5**
of which: equipment		3629.9	7.4	6.5	23.6	-14.7	18.3	**-5.0**	**-2.0**	**3.5**
Exports (goods and services)		99393.0	203.3	6.6	0.2	6.9	6.8	**7.5**	**3.5**	**4.9**
Imports (goods and services)		83555.9	170.9	7.1	1.5	5.7	8.0	**6.6**	**3.0**	**4.3**
GNI (GDP deflator)		32726.6	66.9	2.5	-0.9	-1.7	5.9	**3.6**	**4.0**	**5.0**
Contribution to GDP growth:	Domestic demand			2.7	1.4	-0.5	3.7	**0.7**	**1.7**	**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	**4.1**	**2.1**	**2.8**
Employment				3.4	2.4	1.8	2.5	**2.6**	**2.7**	**2.5**
Unemployment rate (a)				3.7	5.1	5.9	6.0	**6.1**	**6.0**	**6.0**
Compensation of employees / head				3.0	1.6	3.6	2.9	**0.9**	**1.4**	**2.6**
Unit labour costs whole economy				2.7	4.9	1.1	1.4	**-1.1**	**0.3**	**0.7**
Real unit labour cost				0.2	0.8	-1.2	0.4	**-4.6**	**-1.0**	**-1.4**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.4	4.1	2.4	1.0	**3.6**	**1.2**	**2.1**
Harmonised index of consumer prices				2.4	2.9	1.7	0.7	**0.1**	**0.4**	**2.4**
Terms of trade of goods				0.1	0.1	0.1	0.6	**0.8**	**0.3**	**0.3**
Trade balance (goods) (c)				-7.9	-3.6	-0.7	-0.6	**-1.1**	**-1.5**	**-1.4**
Current-account balance (c)				9.2	6.1	5.7	5.5	**4.8**	**4.9**	**4.2**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	5.2	4.0	3.5	**4.9**	**5.1**	**4.5**
General government balance (c)				2.1	0.2	0.7	1.4	**0.2**	**0.5**	**0.5**
Cyclically-adjusted budget balance (d)				1.9	2.6	2.3	2.7	**0.8**	**0.9**	**0.4**
Structural budget balance (d)				-	2.6	2.3	2.5	**0.8**	**0.9**	**0.4**
General government gross debt (c)				9.4	22.1	23.4	23.0	**21.3**	**22.7**	**22.0**

(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.