LUXEMBOURG

Growth is projected to strengthen significantly to 4% by 2019, boosted by dynamic domestic demand and growth in the domestic financial sector, which will foster exports. Wage growth, which is projected to pick up following automatic wage indexation at the beginning of the year, is a factor behind higher inflation. The unemployment rate is declining slowly, but, at around 6%, remains high, at least by Luxembourg standards.

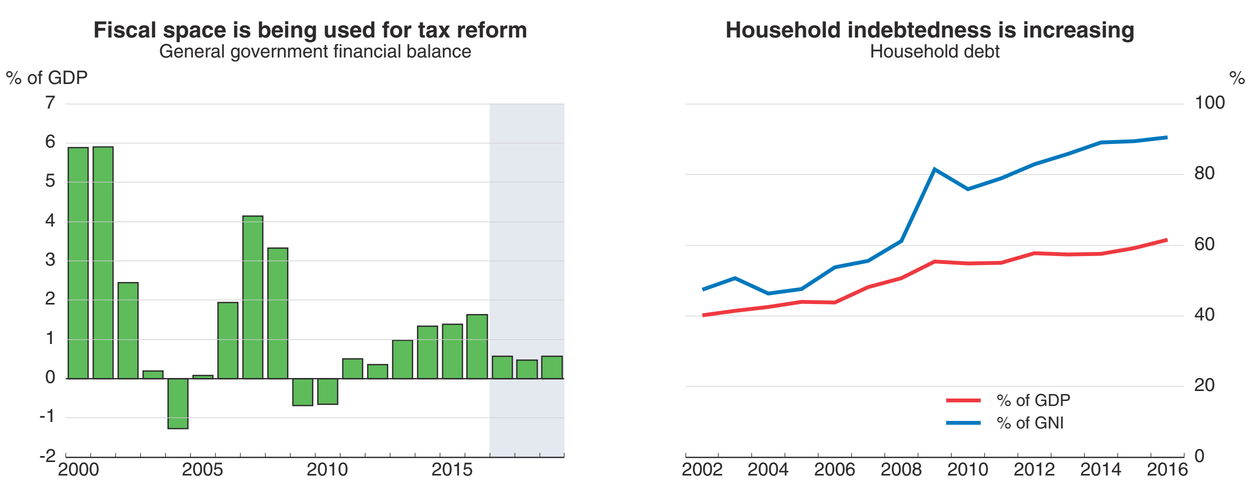
Fiscal space is appropriately being used for tax reform, introducing welcome incentives for labour market participation, such as an optional individual taxation for married or co-habiting workers. Further pension reform would help to ensure long-term fiscal sustainability, and increases in taxes on transport fuels would promote green growth. The strategic focus of the government on digital technology and renewable energy is welcome, but needs to be complemented by policies facilitating the relocation of labour and better aligning the supply of skills with labour market needs.

The high dependence on financial sector developments entails risks, and hence efforts to diversify the economy are welcome. The low level of interest rates, together with the constrained supply of housing, may contribute to strong house price increases. Risks associated with increasing house prices and high household indebtedness should be closely monitored and, if necessary, addressed by additional macro-prudential measures.

Economic growth is driven by domestic demand

Economic growth remains robust on the back of resilient household consumption and strengthening wage growth. The financial sector, particularly investment funds, is benefitting from accommodative monetary policy, and assets under management continue to grow. The unemployment rate is declining slowly, as many newly created jobs continue to be filled by non-residents. The external position remains strong, with financial services trade making up for the deficit in goods and non-financial services. The general

Luxembourg



Source: OECD Economic Outlook 102 database; and Financial balance sheets, OECD National Accounts Statistics.

StatLink http://dx.doi.org/10.1787/888933631912

Luxembourg: **Demand, output and prices**

	2014	2015	2016	2017	2018	2019
	Current prices EUR billion	Percentage changes, volume (2010 prices)				
GDP at market prices	50.0	2.9	3.1	3.0	3.8	3.9
Private consumption	15.2	3.3	2.4	1.6	2.7	3.3
Government consumption	8.3	2.6	2.0	2.4	2.9	3.0
Gross fixed capital formation	9.5	-8.0	0.5	7.7	1.6	3.9
Final domestic demand	33.1	-0.2	1.8	3.4	2.4	3.4
Stockbuilding[1]	- 0.1	1.0	-0.1	-1.2	0.1	0.0
Total domestic demand	32.9	1.4	1.6	1.6	2.6	3.4
Exports of goods and services	104.1	6.7	2.2	4.8	4.9	4.6
Imports of goods and services	87.0	7.1	2.1	4.5	4.5	4.6
Net exports[1]	17.1	1.4	0.9	2.3	2.7	1.8
Memorandum items						
GDP deflator	_	1.3	-1.3	2.0	1.9	2.3
Harmonised index of consumer prices	_	0.1	0.0	2.1	2.1	2.2
Harmonised index of core inflation[2]	_	1.7	1.0	1.5	2.1	2.2
Unemployment rate (% of labour force)	_	6.8	6.4	6.0	5.7	5.5
Household saving ratio, net (% of disposable income)	_	16.5	17.5	18.4	18.1	18.2
General government financial balance (% of GDP)	_	1.4	1.6	0.6	0.5	0.6
General government gross debt (% of GDP)	_	29.0	27.7	29.6	31.9	34.1
General government debt, Maastricht definition (% of GDP)	_	22.0	20.8	22.7	25.0	27.2
Current account balance (% of GDP)	_	5.1	4.8	3.7	3.4	3.5

1. Contributions to changes in real GDP, actual amount in the first column.
2. Harmonised index of consumer prices excluding food, energy, alcohol and tobacco.
Source: OECD Economic Outlook 102 database.

StatLink http://dx.doi.org/10.1787/888933632843

government budget is in surplus, gross public debt is low at 20% of GDP, and net public debt is negative, reflecting assets held by the social security administration.

Structural reforms are needed to improve housing market outcomes

A multi-year tax reform will reduce corporate income tax rates further and introduce additional corporate investment tax credits for zero-emitting cars and software acquisition. In personal taxation, the option of individual taxation for married or co-habiting workers will be introduced, alongside new tax credits for electric and hybrid cars. The reform will encourage business investment and possibly make the tax system more gender neutral, but tax revenues are likely to fall. Nonetheless, after declining significantly in 2017, the general government fiscal surplus is projected to remain stable as a share of GDP in both 2018 and 2019.

The financial sector remains the main driver of economic growth. Although the financial sector appears resilient and well-capitalised, its size and interconnectedness also give rise to vulnerabilities. Strong linkages between subsidiaries of foreign banks and their parents abroad, as well as between banks and investment funds, could lead to maturity and other mismatches and propagate shocks within the financial system. Strong increases in housing prices and rising household indebtedness, to which domestically-oriented banks are most exposed, should be addressed by additional macro-prudential measures, such as limits to loan-to-value or loan-to-income ratios.

House prices have been growing strongly, both in relation to income and the level of rents, and are likely to reflect existing supply bottlenecks. Weak incentives to use the land available for construction should be strengthened by a reform of land planning and complemented by the introduction of time-limited building permits and increased taxation of non-used constructible land. Measures to support affordable housing may eventually increase the limited supply of social housing. Existing fiscal measures that stimulate housing demand, such as the tax deductibility of mortgage interest, should be withdrawn.

Growth is projected to pick up

Growth is projected to rise to about 4% by 2019. Private consumption will benefit from firming wage growth, while private investment will be boosted by the continuing reduction in corporate income tax rates in 2018. Activity will also be supported by continuing accommodative monetary conditions in the euro area and robust financial services exports. A new round of wage indexation, which may take place in the course of 2018, would lift both inflation and disposable incomes.

Strong financial linkages between subsidiaries of foreign banks in Luxembourg and their parents abroad, possibly even outside the EU regulatory and supervisory framework, may transmit external shocks into the domestic economy. On the upside, Luxembourg's established financial centre may become even more attractive in the wake of Brexit, especially if Luxembourg keeps its attractiveness to the associated highly qualified international labour force.