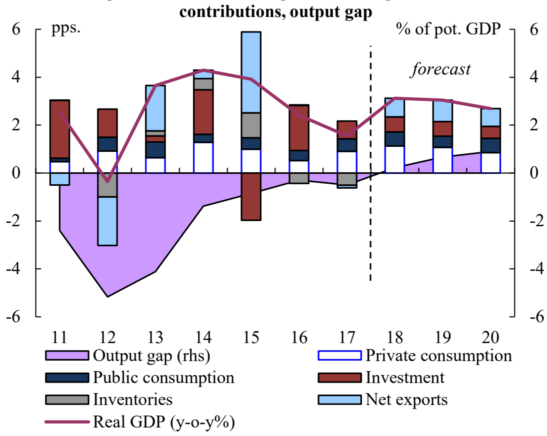
16. LUXEMBOURG
Growth momentum begins to fade

GDP growth in Luxembourg is forecast to rise to an annual average rate of 3.1% in 2018. The economy is largely driven by domestic demand, which is benefiting from improving labour market conditions. But growth is set to moderate in 2019 and 2020 as domestic demand wanes. Inflation is set to average 2.0% in 2018 and 2019 before cooling to 1.8% in 2020. The headline budget surplus is forecast to remain high.

Growth regained momentum in 2018…

After slowing to 1.5% in 2017, economic growth in Luxembourg is showing regained momentum. GDP growth is forecast to average 3.1% in 2018, driven mainly by private consumption and investment, with less support expected from the external environment. However, historical figures need to be taken with caution given the frequent and substantial revisions to Luxembourg's national accounts data.

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



Employment growth averaged 3.8% (y-o-y) in the first half of 2018, compared to 3.4% in 2017 and unemployment continued to fall. Private consumption should benefit from the improvement in the labour market, including stronger resident employment creation, while disposable income is set to receive a boost from taxation reforms and a new wage indexation applied from August. Private investment should receive support from continuing corporate tax reductions, favourable financing conditions and high levels of capacity utilisation.

The international financial sector, traditionally Luxembourg's main growth engine, was still profitable, despite subdued growth and recent developments in global financial markets. Bank lending dropped in the first quarter of 2018 and net investment inflows to the funds industry slowed in the second quarter. While growth is set to continue, the moderation in the external environment has weakened growth prospects for financial services, as well as for the economy as a whole.

…but is expected to lose steam.

Several factors suggest slightly less dynamic economic growth over the forecast horizon. With the momentum of foreign trade losing dynamism, economic growth is set to be supported mainly by domestic demand. In time, as employment gains become smaller and the impact of tax reforms fade away, domestic demand will also lose some of its lustre. GDP growth is expected to moderate to 3.0% in 2019 and 2.7% in 2020.

As a small open economy with strong trade and financial links in international markets, Luxembourg remains exposed to materialising risks. Heightened trade and political tensions, and any escalation of the financial turmoil that may ensue, could result in a less benign outcome for Luxembourg's economy. Overall, at the current juncture, uncertainty has increased and risks remain tilted to the downside.

Progressive shift of inflation drivers

HICP inflation bounced up to 2.1% in 2017 from zero in 2016, mainly as a result of oil price movements. Higher oil prices are expected to continue feeding into higher headline inflation in 2018 and 2019, although their effect should gradually ease. Downside factors, such as subsidies for child and healthcare services introduced in November 2017, are expected to reduce inflation at 2.0% in 2018. As these effects dissipate, domestic price pressures, including from past wage increases, will reassert their influence and headline inflation should fall from 2.0% in 2019 to 1.8% in 2020.

The general government surplus will slightly decline

The general government surplus is projected to marginally decline to 1.3% of GDP in 2018, compared to 1.4% in 2017. Revenues should remain buoyant underpinned by both direct and indirect taxes. A moderate increase in corporate income tax revenues is expected to be accompanied by a stronger increase in payroll taxes. In addition, VAT revenues should show strong growth in line with the expected acceleration of private consumption.

In 2018, planned increases in government expenditure growth are expected to outpace revenue growth. Intermediate consumption is expected to bounce back after having remained almost flat over the previous year. Public investment, which is already high, is expected to expand further. In addition, the implementation of a multilingual education plan, a childcare voucher scheme and a reform of parental leave, are all projected to add to the increase in expenditure growth.

In 2019, the general government surplus is expected to decline to 1.2% of GDP. Revenue growth will remain buoyant, in line with strong underlying economic growth, although it will be outpaced by growth in government expenditure

Based on a no-policy-change assumption, the general government surplus is projected to decline further in 2020 as growth slows. The projection includes the purchase of a military plane, for a cost estimated at around 0.3% of GDP, the delivery of which is planned in 2020.

The structural surplus is expected to decline over the forecast horizon, but remain comfortably in positive territory.

Luxembourg's debt-to-GDP ratio increased to 23% in 2017. It is expected to decline over the forecast horizon, even if new debt has to be issued to finance the deficit of the central government, as the surplus of the social security sector cannot be used for this purpose.

Table II.16.1:

Main features of country forecast - LUXEMBOURG

	2017			Annual percentage change						
mio EUR	Curr. prices	% GDP		99-14	2015	2016	2017	2018	2019	2020
GDP	55299.4	100.0		3.3	3.9	2.4	1.5	**3.1**	**3.0**	**2.7**
Private Consumption	16964.7	30.7		2.5	3.2	1.7	3.0	**3.7**	**3.5**	**2.7**
Public Consumption	9421.8	17.0		3.5	2.8	2.5	3.1	**3.4**	**2.7**	**3.4**
Gross fixed capital formation	10459.6	18.9		4.5	-9.9	10.4	4.0	**3.4**	**3.2**	**2.7**
of which: equipment	4206.4	7.6		6.9	-19.1	15.8	14.8	**3.4**	**3.4**	**2.6**
Exports (goods and services)	123361.5	223.1		6.6	5.3	3.8	-1.9	**3.2**	**2.7**	**2.2**
Imports (goods and services)	104952.4	189.8		7.1	4.3	4.5	-2.2	**3.3**	**2.6**	**2.2**
GNI (GDP deflator)	39199.4	70.9		1.2	5.8	2.8	6.0	**3.2**	**3.0**	**2.7**
Contribution to GDP growth:		Domestic demand		2.4	-0.5	2.8	2.2	**2.4**	**2.1**	**2.0**
		Inventories		0.0	1.0	-0.4	-0.5	**0.0**	**0.0**	**0.0**
		Net exports		1.0	3.4	0.0	-0.1	**0.8**	**0.9**	**0.7**
Employment				3.2	2.6	3.0	3.4	**3.6**	**3.3**	**2.8**
Unemployment rate (a)				4.2	6.5	6.3	5.6	**5.3**	**5.2**	**5.2**
Compensation of employees / head				3.1	1.6	0.9	3.3	**2.2**	**2.6**	**2.3**
Unit labour costs whole economy				3.0	0.3	1.5	5.2	**2.7**	**2.8**	**2.4**
Real unit labour cost				0.0	0.7	0.6	3.0	**0.7**	**0.9**	**0.7**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				3.1	-0.4	0.9	2.2	**2.0**	**1.8**	**1.7**
Harmonised index of consumer prices				2.5	0.1	0.0	2.1	**2.0**	**2.0**	**1.8**
Terms of trade of goods				0.4	-3.1	5.0	0.4	**0.5**	**-0.3**	**0.0**
Trade balance (goods) (c)				-5.5	0.1	1.2	1.2	**1.2**	**1.2**	**1.2**
Current-account balance (c)				5.4	1.9	2.0	4.4	**4.2**	**3.8**	**3.3**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				4.7	0.5	-1.0	3.2	**3.1**	**2.9**	**2.6**
General government balance (c)				1.7	1.3	1.6	1.4	**1.3**	**1.2**	**0.9**
Cyclically-adjusted budget balance (d)				1.9	1.3	1.4	1.6	**1.3**	**1.1**	**0.8**
Structural budget balance (d)				-	1.1	1.4	1.6	**1.3**	**1.1**	**0.8**
General government gross debt (c)				12.8	22.2	20.7	23.0	**21.4**	**20.8**	**20.6**

(a) as % of total labour force. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.