16. LUXEMBOURG

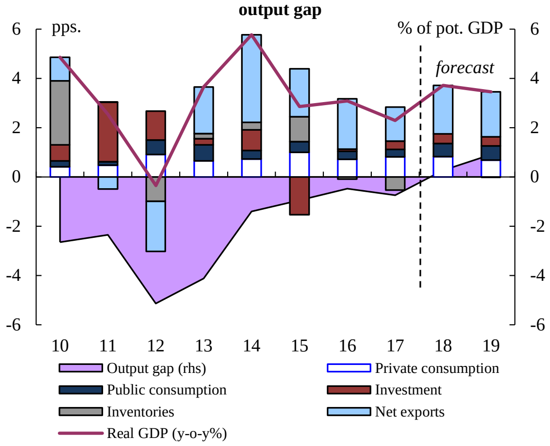
Volatile growth but strong job creation

Economic growth is projected to rebound in 2018 and then slow slightly in 2019. Employment growth is set to remain solid and unemployment is forecast to continue falling. Inflation is projected to drop below 2%, driven initially by energy prices in 2018 and then sustained by domestic price pressures. In 2017, the headline surplus decreased only slightly as windfall revenues, particularly from corporate income taxation, helped to compensate for the impact of the tax-decreasing reform.

Unexpected slowdown in 2017

In 2017, Luxembourg's economic growth slowed to 2.3%, from 3.1% in 2016. The slowdown was in marked contrast with the upward trends observed in economic indicators for the same period and needs to be taken with caution given the frequent and substantial revisions to Luxembourg's national accounts-data. The slowdown was mainly due to a weaker external demand, specifically to a reduced activity in the financial services sector. Nevertheless, nominal GDP growth strengthened, reflecting positive price effects from the robust performance of financial markets.

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



Stronger growth ahead

Positive signals continued to arrive in the first months of 2018, including from stronger job creation, while the fund investment industry set new records in January. Luxembourg's economic prospects therefore remain favourable, as the outlook for the external environment has brightened and consumer sentiment indicators are at high levels.

Economic growth is projected to strengthen in 2018, driven by robust domestic demand and net services exports. Private consumption growth is expected to remain strong, supported by disposable income growth. The latter will be sustained, in particular, by a further improvement in the labour market, lingering effects from the tax reform and the wage indexation projected for 2018-Q3, which will more than offset the continued negative impact of higher oil prices. The contribution to growth from the financial sector, traditionally Luxembourg's main growth engine, is projected to strengthen, underpinned by the euro area's strong expansion. Indeed, the latest indicators suggest a continuation of these trends. Overall, GDP is forecast to grow by 3.7% in 2018.

In 2019, private consumption growth is projected to lose some momentum, as labour market conditions improve more slowly and past income gains fade away. The external sector, driven by financial services exports, is expected to decline somewhat but remain robust, in line with financial markets prospects. GDP growth looks set at 3.5%.

Strong labour market

In 2017, total employment grew by 3.3%, up from 3.0% in 2016. The strong economic expansion should support job creation, which is projected to remain robust in both 2018 and 2019. The recent rise in national employment, which reduced the unemployment rate to 5.6% in 2017 from 6.3% in 2016, is forecast to continue in 2018, before moderating in 2019. All in all, unemployment should fall to 5.3% in 2018 and 5.2% in 2019.

A change 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 feed into high headline inflation in 2018, although less markedly than in 2017 and should be partly offset by the subsidies in childcare and healthcare services introduced in November 2017, pushing inflation down to 1.5%. As these effects dissipate, domestic price pressures, including from past wage increases, should drive the headline inflation to 1.7% in 2019.

The general government surplus surprised positively

The general government surplus is estimated at 1.5% of GDP in 2017. Revenue collection increased by 6.0%. Windfall revenues from corporate income taxes and from payroll taxes compensated for the impact of the tax-reducing reform enacted by the government at the start of the year (a drop in revenues of 0.8 pps of GDP). In addition, buoyant revenues from indirect taxes offset the loss in VAT revenues, from e-commerce related transactions (equivalent to 0.5% of GDP), which were due to the cut from 30% to 15% in the share of VAT revenues that Luxembourg retains.

Expenditure growth increased broadly at the same pace as revenues, driven by the automatic wage indexation that took place at the start of 2017 and to which a large share of public expenditure is linked. The wage bill expanded following the implementation of the wage agreement in the public sector. Public investment, by contrast, expanded less than initially expected in the budget as some projects were delayed.

In 2018, the general government surplus is expected to decline to 0.9% of GDP. Buoyant revenue growth underpinned by strong underlying economic growth will be outpaced by growth in government expenditure, especially high spending in infrastructure investment.

Based on a no-policy-change assumption, the general government surplus is projected to slightly decline in 2019 as growth slows. The projection does not include the purchase of a military plane, for a cost estimated at around 0.3% of GDP, the delivery of which has been postponed to 2020.

In 2017 the structural balance is expected to stabilise at about 1¾% of GDP as the negative output gap widens. In 2018 and 2019, in line with the projected deterioration of the headline position and as the output gap moves to positive territory the structural balance surplus is expected to decline.

Luxembourg's debt-to-GDP ratio increased to 23% in 2017. It is expected to decline only slightly over the forecast horizon, as 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

		2016			Annual percentage change					
	mio EUR	Curr. prices	% GDP	98-13	2014	2015	2016	2017	2018	2019
GDP		53004.8	100.0	3.5	5.8	2.9	3.1	**2.3**	**3.7**	**3.5**
Private Consumption		16036.7	30.3	2.4	2.3	3.3	2.4	**2.7**	**2.7**	**2.3**
Public Consumption		8849.1	16.7	3.5	2.0	2.6	2.0	**1.8**	**3.2**	**3.4**
Gross fixed capital formation		9112.4	17.2	4.6	4.3	-8.0	0.5	**1.9**	**2.4**	**2.2**
of which: equipment		3168.1	6.0	6.8	5.3	-16.5	-7.0	**11.2**	**0.5**	**2.4**
Exports (goods and services)		117282.5	221.3	6.4	14.0	6.9	2.7	**3.9**	**4.1**	**3.7**
Imports (goods and services)		98675.5	186.2	6.8	14.6	7.1	2.1	**3.9**	**3.8**	**3.5**
GNI (GDP deflator)		36048.9	68.0	1.6	2.5	5.4	5.7	**-0.1**	**3.7**	**2.5**
Contribution to GDP growth:	Domestic demand			2.4	1.9	-0.1	1.1	**1.5**	**1.8**	**1.6**
	Inventories			0.0	0.3	1.0	-0.1	**-0.5**	**0.0**	**0.0**
	Net exports			1.1	3.6	1.9	2.0	**1.4**	**2.0**	**1.8**
Employment				3.3	2.6	2.6	3.0	**3.3**	**3.6**	**3.1**
Unemployment rate (a)				4.0	6.0	6.5	6.3	**5.6**	**5.3**	**5.2**
Compensation of employees / head				3.0	2.2	3.0	0.7	**2.8**	**2.6**	**2.2**
Unit labour costs whole economy				2.9	-0.9	2.8	0.7	**3.8**	**2.5**	**1.9**
Real unit labour cost				0.1	-2.5	1.4	2.0	**1.7**	**1.0**	**0.4**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.8	1.6	1.3	-1.3	**2.1**	**1.4**	**1.5**
Harmonised index of consumer prices				2.5	0.7	0.1	0.0	**2.1**	**1.5**	**1.7**
Terms of trade of goods				0.3	0.8	-2.2	0.3	**-0.3**	**-1.4**	**0.5**
Trade balance (goods) (c)				-6.4	1.6	-0.5	-1.4	**-0.7**	**-0.9**	**-0.7**
Current-account balance (c)				4.7	-0.9	2.5	3.5	**2.7**	**3.0**	**2.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				3.9	-0.3	1.1	0.5	**3.5**	**3.7**	**3.4**
General government balance (c)				1.9	1.3	1.4	1.6	**1.5**	**0.9**	**0.7**
Cyclically-adjusted budget balance (d)				1.9	1.9	1.8	1.8	**1.8**	**0.8**	**0.3**
Structural budget balance (d)				-	1.9	1.6	1.8	**1.8**	**0.8**	**0.3**
General government gross debt (c)				11.9	22.7	22.0	20.8	**23.0**	**22.6**	**22.5**

(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.