12. LUXEMBOURG

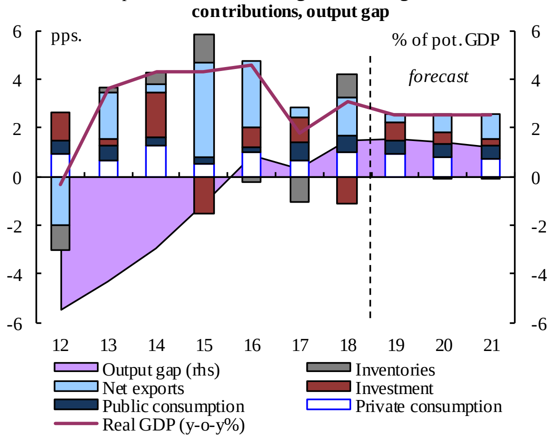
Steady growth ahead

Real GDP is set to grow at a steady pace over the forecast period. With prospects for external trade weakening, growth is expected to be mainly driven by domestic demand, supported by stronger labour market conditions. Inflation is set to fall well below 2.0% in 2019 and 2020, reflecting base effects related to energy, before returning again to almost 2.0% in 2021. The headline budget surplus is forecast to decline, but remains high.

A moderate slowdown in 2019

Real GDP growth in Luxembourg is expected to reach 2.6% in 2019, a moderate slowdown compared with the 3.1% estimate for 2018. Growth was mainly supported by private consumption, while investment rebounded following the sharp drop recorded last year. The contribution from non-financial services exports improved after weakening somewhat in recent years, which, according to the national statistical institute, was most likely due to exceptional transactions by foreign-owned, non-financial corporations operating in Luxembourg. [111]

Graph II.12.1: **Luxembourg - Real GDP growth and contributions, output gap**



Overall, export growth remained subdued, reflecting weaker activity in the international financial sector, with net investment inflows to the fund industry stagnant amid increased uncertainty. In value terms, funds have continued to expand despite some volatility in global financial markets. Domestic banks have maintained their profitability, mostly by increasing lending. In sum, growth is set to continue at a steady pace at around 2½% over the forecast horizon, driven by domestic demand, with a positive, though weak contribution from the external sector.

Steady growth ahead

Private consumption, the main driver of domestic demand growth, is expected to slow down but remain strong after 2019, benefitting from favourable labour market conditions. In addition to budgetary measures, wages (and pensions) are expected to be raised by the year-end 2019, once the indexation mechanism is triggered, and then again by the second quarter of 2021.

As a small open economy with strong trade and financial links with international markets, Luxembourg remains highly exposed to external risks. Uncertainty, and any financial turmoil that may ensue, could result in a less benign outcome for Luxembourg's economy.

Strong labour market

In 2019, employment growth is expected to remain around 3.7%, its highest rate since the crisis but job creation is likely to slow in 2020 and 2021. Employment among residents is projected to follow a broadly similar trajectory but at a lower level, with unemployment projected to remain around 5½% over the forecast period.

A shift in inflation drivers

HICP inflation is forecast to fall to 1.7% in 2019 and 1.6% in 2020 from 2.0% in 2018. Base effects related to lower energy inflation are expected to ease headline inflation in 2019 and 2020. Meanwhile, domestic price pressures, including from wage increases, are set to reassert their influence, although those will be partly offset by new measures, including free public transport on the national network by 2020. Headline inflation should reach 1.9% by 2021.

[111] This forecast does not integrate any assumption on the impact of those "exceptional transactions". The latest revision (+0.8 pps., on average, per year in real GDP between 2015 and 2018) might suggest a lower impact than previously envisaged, although this hypothesis cannot be confirmed due to insufficient information and given the frequent and substantial revisions to Luxembourg's national accounts.

The general government surplus is set to decline from a high level

The general government surplus is expected to decline to 2.3% of GDP in 2019, from 2.7% of GDP in 2018.

In 2019, total revenues are projected to increase sharply underpinned by direct taxes and to a lesser extent by indirect taxes. Revenues from current taxes on income and wealth are expected to post a strong increase, in particular as revenues from corporate taxes have increased substantially, partly thanks to the introduction of the automatic tax declaration, which accelerates revenues collection. Payroll taxes also benefit from the dynamic labour market. VAT revenues are expected to increase in proportion to private consumption growth and will only partially be dampened by the loss of residual revenues from e-commence transactions.

In 2019 expenditure growth should also display a dynamic trend. In particular, a significant increase is projected for public investment. Recent measures announced, such as the compensation of employees and current transfers, are expected to boost expenditure by 0.4 pps. of GDP.

The general government surplus is projected to decline further in 2020 when revenues are set to be impacted by recent government measures such as the introduction of free public transport and the impact of a further reduction in corporate taxation. The purchase of a military plane will substantially increase public investment. The surplus is projected then to fall to 1.4% of GDP in 2020.

On a no-policy-change scenario, the general government surplus is estimated to remain stable at 1.4% of GDP in 2021.

The structural surplus is expected to decline in 2019 and 2020 and remain broadly stable in 2021, while remaining comfortably positive.

Luxembourg's debt-to-GDP ratio is projected to decline to 19.6% in 2019, from 21.0% in 2018. It is expected to decline further over the forecast horizon as a favourable snowball effect will counterbalance the impact of the new debt issuance to finance the projected deficits of the central government.

Table II.12.1:

Main features of country forecast - LUXEMBOURG

	2018			Annual percentage change						
	mio EUR Curr. prices	% GDP	00-15	2016	2017	2018	2019	2020	2021
GDP	60053.1	100.0	3.1	4.6	1.8	3.1	**2.6**	**2.6**	**2.6**
Private Consumption	17874.0	29.8	2.3	3.4	2.2	3.3	**3.1**	**2.7**	**2.5**
Public Consumption	10004.5	16.7	3.1	1.0	4.7	4.1	**3.2**	**2.9**	**3.1**
Gross fixed capital formation	10096.4	16.8	2.9	4.6	5.6	-5.9	**4.5**	**2.9**	**1.6**
of which: equipment	3164.0	5.3	3.9	-1.0	16.3	-22.2	**5.0**	**3.0**	**1.4**
Exports (goods and services)	127047.7	211.6	6.1	2.6	0.7	0.5	**1.7**	**1.7**	**2.3**
Imports (goods and services)	105419.8	175.5	6.5	1.6	0.6	-0.3	**1.9**	**1.7**	**2.2**
GNI (GDP deflator)	38255.6	63.7	1.4	2.2	3.1	1.9	**12.1**	**3.0**	**2.4**
Contribution to GDP growth: Domestic demand			1.9	2.0	2.4	0.5	**2.2**	**1.8**	**1.6**
Inventories			0.1	-0.2	-1.1	0.9	**0.0**	**0.0**	**0.0**
Net exports			1.2	2.7	0.4	1.6	**0.3**	**0.7**	**1.0**
Employment			3.1	3.0	3.4	3.7	**3.7**	**3.4**	**3.1**
Unemployment rate (a)			4.5	6.3	5.6	5.5	**5.3**	**5.3**	**5.3**
Compensation of employees / head			3.0	0.8	3.0	3.3	**3.2**	**2.5**	**2.3**
Unit labour costs whole economy			3.0	-0.7	4.6	3.9	**4.3**	**3.3**	**2.8**
Real unit labour cost			0.2	-1.5	2.8	1.3	**2.1**	**1.4**	**0.8**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			2.7	0.8	1.7	2.5	**2.2**	**1.9**	**2.0**
Harmonised index of consumer prices			2.5	0.0	2.1	2.0	**1.7**	**1.6**	**1.9**
Terms of trade of goods			0.4	2.0	-1.4	0.4	**0.2**	**0.0**	**0.0**
Trade balance (goods) (c)			-4.8	-1.1	-2.0	-2.0	**-2.1**	**-2.1**	**-1.9**
Current-account balance (c)			3.7	0.2	-0.9	0.0	**4.4**	**4.4**	**4.4**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			3.1	-0.4	-1.5	-0.7	**3.7**	**3.7**	**3.6**
General government balance (c)			1.6	1.8	1.4	2.7	**2.3**	**1.4**	**1.4**
Cyclically-adjusted budget balance (d)			2.0	1.4	1.2	2.0	**1.6**	**0.8**	**0.9**
Structural budget balance (d)			-	1.4	1.2	2.0	**1.6**	**0.8**	**0.9**
General government gross debt (c)			13.6	20.1	22.3	21.0	**19.6**	**19.2**	**18.6**

(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.