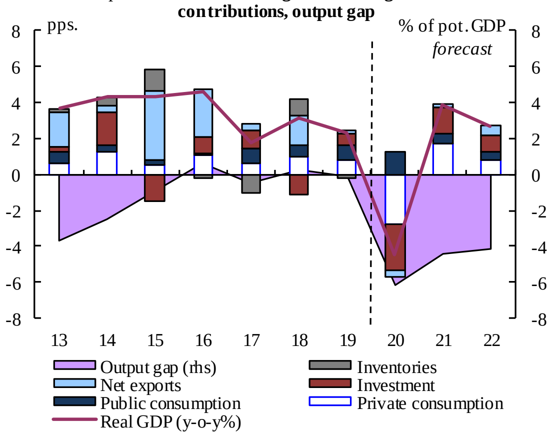
12. LUXEMBOURG

The COVID-19 crisis has led to a large fall in domestic demand, while the external sector has performed relatively well due to trade in financial services. For 2020, a significant decline in real GDP growth is expected. This contraction is mitigated by strong fiscal measures that pave the way for a rebound of real GDP growth in 2021, before returning to trend in 2022. Consequently, the general government balance will slip into deficit. Government debt will increase, but remain at a low level.

A domestic demand driven recession in 2020

The COVID-19 crisis will push Luxembourg's economy into recession in 2020 with real GDP forecast to decline by 4½%, compared to an already low 2.3% in 2019. Growth in 2021 is expected to rebound to around 4% before settling down to 2¾% in 2022, when GDP is expected to return to its 2019 level. [113]

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



In the first half of 2020, domestic demand declined strongly as a result of lockdown measures taken to control the COVID-19 pandemic. Private consumption and investment fell by close to 20% in the second quarter (year-on-year). The strong fiscal response by the government will partly mitigate the fall in domestic demand in 2020. International trade in goods and non-financial services declined significantly during the first six months of this year, while trade in financial services actually increased, resulting in a forecast of a limited negative contribution from net exports to real GDP growth in 2020. This is mainly the result of the relatively good performance of the financial sector in Luxembourg. The strong rebound in financial markets and the high level of teleworking in the financial sector led to less disruption in activity than what might have been expected under the circumstances.

Outlook remains highly uncertain

A broad-based recovery driven by higher domestic demand is expected in 2021. Private consumption should be supported by growth in compensation, while gross fixed capital formation recovers with the support of government investment. In 2022, positive contributions from both domestic demand and net export should bring the economy back to a growth rate of 2¾%. There is a downside risk to the forecast from a possible larger-than-assumed impact on trade in services of the UK leaving the Single Market, considering that bilateral services trade with the UK is relatively large.

Rising unemployment and lower inflation

The health crisis has led to an increase in unemployment. The rebound in economic activity after the lock down and the government's short-term work scheme have supported employment levels. However, weak survey outlooks for employment and an expected increase in bankruptcies point to higher unemployment levels over the forecast period. The strong employment growth of recent years is expected to slow down from around 3% to 2% over the forecast horizon. The slowdown in the labour market is projected to put pressure on wages while disposable income is supported by government measures in 2020 and should recover in 2021 and 2022. In this context, specific measures for teleworking and income tax were introduced for cross-border workers.

Headline inflation is forecast to fall to 0.2% in 2020, mainly due to the sharp decline in oil prices and the introduction of free public transport. A rebound to 1.5% is expected in 2021, partly due to the implementation of a carbon tax, and to 1.8% in 2022 when the next wage indexation level is reached.

(113) Luxembourg's national accounts are subject to sometimes substantial revisions, amongst others due to methodological difficulties related to the important role of multinational firms and financial services in external trade.

A spike in the deficit followed by a decline

The general government balance recorded a surplus of 2.4% of GDP in 2019. In 2020, public finances are expected to deteriorate sharply and the general government balance is forecast to slip into a deficit of 5.1% of GDP. Cumulated revenues in 2020 for the central government dropped by around 10% on an annual basis, based on figures up to August. The large drop in corporate income tax revenues, in spite of the financial sector's resilience, is partly explained by a base effect related to exceptional revenues in the previous year. A substantial decline is also expected in revenues from indirect taxes, especially VAT, due to both the decline in private consumption and the government-accelerated reimbursement of VAT credit. On the positive side, personal income tax revenues are still expected to increase, as the replacement income schemes put in place by the government support households' disposable income.

The government promptly adopted two different packages of measures to combat the pandemic and relaunch the economy. Their direct budgetary impact is estimated at 3.1% of GDP in 2020. In particular, the existing short-time working scheme has been extended to all companies affected by the current crisis, new aid schemes to support SMEs in temporary financial difficulty have been introduced, and procedures for requesting special leave for family reasons due to school closure have been simplified. Public investment is forecast to increase sharply on the back of the government's countercyclical fiscal policy. In this regard, the additional expenditures on health care and crisis management and the purchase of a military plane have boosted government investment. The take up of liquidity measures such as credit guarantees to companies has been modest so far.

The deficit is expected to decrease to 1.3% of GDP in 2021, driven by the economic recovery and by the phasing-out of temporary measures taken in 2020. However, some of these measures will still have a deficit-increasing impact in 2021. This forecast does not include any measures funded by Recovery and Resilient Facility grants. Under a no-policy-change assumption, the deficit is forecast to further improve to 1.1% in 2022. The public debt is expected to increase to 25.4% of GDP in 2020, 27.3% in 2021 and 28.9% in 2022.

Table II.12.1:

Main features of country forecast - LUXEMBOURG

	2019			Annual percentage change					
mio EUR	Curr. prices	% GDP	01-16	2017	2018	2019	2020	2021	2022
GDP	63516.3	100.0	2.9	1.8	3.1	2.3	**-4.5**	**3.9**	**2.7**
Private Consumption	18730.4	29.5	2.2	2.2	3.3	2.8	**-9.4**	**6.0**	**2.6**
Public Consumption	10858.3	17.1	2.9	4.7	4.1	4.8	**7.2**	**2.9**	**2.7**
Gross fixed capital formation	10721.4	16.9	3.5	5.6	-5.9	3.9	**-15.5**	**9.6**	**5.4**
of which: equipment	3585.1	5.6	5.4	16.3	-22.2	12.5	**-15.6**	**13.8**	**1.3**
Exports (goods and services)	132592.1	208.8	5.4	0.7	0.5	0.8	**-3.3**	**2.0**	**1.9**
Imports (goods and services)	109733.3	172.8	5.8	0.6	-0.3	0.9	**-3.7**	**2.3**	**1.9**
GNI (GDP deflator)	41602.6	65.5	1.2	3.1	1.9	5.2	**-6.9**	**6.6**	**4.5**
Contribution to GDP growth: Domestic demand			1.9	2.4	0.5	2.3	**-4.1**	**3.7**	**2.1**
Inventories			0.0	-1.1	0.9	-0.2	**0.0**	**0.0**	**0.0**
Net exports			1.0	0.4	1.6	0.2	**-0.4**	**0.2**	**0.5**
Employment			2.9	3.4	3.7	3.6	**2.0**	**2.0**	**2.1**
Unemployment rate (a)			4.8	5.5	5.6	5.6	**6.6**	**7.1**	**7.1**
Compensation of employees / head			2.7	3.0	3.3	1.7	**-5.3**	**2.3**	**3.1**
Unit labour costs whole economy			2.7	4.6	3.9	3.0	**1.1**	**0.4**	**2.5**
Real unit labour cost			0.1	2.8	1.3	-0.4	**1.3**	**-1.0**	**1.2**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			2.6	1.7	2.5	3.4	**-0.2**	**1.4**	**1.3**
Harmonised index of consumer prices			2.2	2.1	2.0	1.6	**0.2**	**1.5**	**1.8**
Terms of trade of goods			0.8	-1.4	0.4	-1.0	**-0.1**	**0.1**	**0.1**
Trade balance (goods) (c)			-4.2	-2.0	-2.0	-3.1	**-2.2**	**-2.7**	**-3.0**
Current-account balance (c)			3.3	-0.9	0.0	2.2	**0.8**	**1.2**	**1.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			2.8	-1.5	-0.7	1.5	**0.1**	**0.6**	**1.1**
General government balance (c)			1.4	1.3	3.1	2.4	**-5.1**	**-1.3**	**-1.1**
Cyclically-adjusted budget balance (d)			1.5	1.5	2.9	2.4	**-2.2**	**0.8**	**0.9**
Structural budget balance (d)			-	1.5	2.9	2.4	**-2.2**	**0.8**	**0.9**
General government gross debt (c)			14.8	22.3	21.0	22.0	**25.4**	**27.3**	**28.9**

(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.