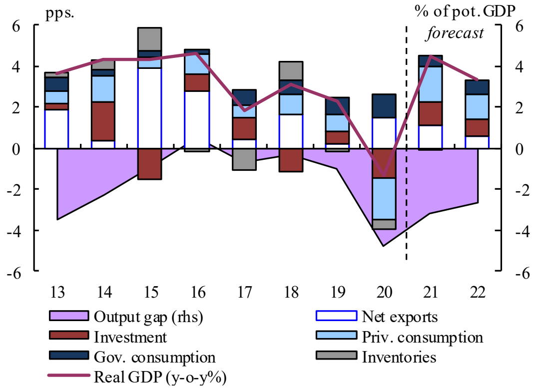
12. LUXEMBOURG

Economic growth in Luxembourg is set to rebound in 2021 after a limited decline in 2020 despite the COVID-19 crisis. The further easing of restrictions as vaccinations progress should allow GDP to grow strongly this year, supported by private consumption and investment, as well as by the strong performance of the external sector. The economy is projected to continue a steady growth path in 2022 and the general government balance is projected to improve gradually.

A strong recovery in 2021 following a limited contraction in 2020

Economic growth is set to rebound in 2021 after a limited drop of just 1.3% in 2020 caused by the COVID-19 crisis. The relative resilience of the Luxembourg economy in 2020 was linked to a very strong performance in the information and communication sector and to the country's large financial sector, which was less affected by the crisis than contact-based services. As more of the population is vaccinated, restrictions should be gradually lifted further from the second quarter of 2021. The increase in private consumption allowed by the easing of restrictions, combined with the strong fundamentals of the Luxembourg economy, will fuel renewed economic growth.

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



Real GDP is forecast to grow by 4.5% in 2021 and by 3.3% in 2022, meaning that it should be above its pre-crisis level already in 2021. Social-distancing measures still in place in the first half of the year are curbing private consumption, particularly for service sectors like restaurants and leisure activities. Support measures have protected household incomes from economic distress and have even allowed a strong increase in the saving rate. Consequently, household consumption should be able to rebound as restrictions are eased.

Risk to outlook remains broadly balanced

Gross fixed capital formation is set to recover with the support of good financing conditions and improved business sentiment. However, possible risks relate to the consequences of a rise in the level of bankruptcies in the most affected sectors and the impact of the new EU-UK trade relationship on international trade in financial services. This is especially important for Luxembourg given the importance of its financial sector and trade in financial services relative to GDP. On the other hand, the continuation of the 2020 strong performance in the external sector presents an upward risk for 2021.

Higher unemployment and lower inflation

The government's short-term work scheme has supported employment levels. However, an expected increase in bankruptcies suggests that unemployment will increase over the forecast period. The strong employment growth of recent years is expected to slow down from above 3% to about 2% in 2021. The growth in employment is expected to be outpaced by the growth of the labour force, pushing the unemployment level close to 7.4% in 2021. The slowdown in the labour market is expected to limit wage growth in 2021 but the labour market situation is forecast to improve in 2022.

Headline inflation is set to rebound from 0% in 2020 to 2.1% in 2021, due to higher energy prices and the implementation of a carbon tax. Headline inflation is expected to moderate to 1.6% in 2022, as energy prices stabilise. Core inflation is projected to ease in 2021 with some downward pressure from the unfolding of the economic crisis and the rise in unemployment.

The general government balance improves gradually

In 2020, the general government balance deteriorated sharply, flipping from a surplus position in 2019 to a deficit of 4.1% of GDP. This reflects the impact of the COVID-19 crisis on economic activity and cost of the measures adopted by the government to support employment and the worst hit sectors. In 2020, general government revenues dropped by 1.2% on an annual basis. Within direct taxes, which decreased by 4.5%, corporate income taxes are expected to have suffered the most in spite of the resilience of the financial sector. The drop is partly explained by a base effect related to the exceptional level of tax collected in the previous year and due to the impact of the tax deferral measures. On the positive side, personal income tax revenues were resilient and are expected to have increased, as the income replacement schemes put in place supported households' disposable income.

Inflated by the cost associated with the different measures to combat the pandemic and to relaunch the economy, public expenditure increased by 14.1% in 2020. Public investment rose sharply by 26%, partially on the back of the government additional expenditures related to the health and crisis management and the purchase of a military plane.

In 2021, the general government balance is expected to improve to a deficit of -0.3% of GDP. In line with the recovery of the economy, revenues should expand again. In particular, corporation taxes are expected to grow after the large drop recorded in 2020, but still to remain below their 2019 level. Expenditure is projected to show only a moderate decline in 2021 as some crisis-related measures continue while other are phase out. Public investment is projected to decline compared to the previous year, as some projects will not be repeated in 2021.

In 2022, the government balance is forecast to improve to a deficit of 0.1% of GDP. Public debt is expected to increase from 24.9% of GDP in 2020 to 27.0% in 2021 and to slightly decrease to 26.8% in 2022.

In the absence of sufficiently detailed information about the national RRP at the time of the cut-off date, this forecast assumes a simplified and linear integration of RRF-financed expenditure, as explained in Box I.2.3 in Chapter I.2.7.

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	**-1.3**	**4.5**	**3.3**
Private Consumption		18730.4	29.5	2.2	2.2	3.3	2.8	**-6.9**	**6.5**	**4.3**
Public Consumption		10858.3	17.1	2.9	4.7	4.1	4.8	**6.9**	**2.7**	**4.2**
Gross fixed capital formation		10721.4	16.9	3.5	5.6	-5.9	3.9	**-8.8**	**7.0**	**5.0**
of which: equipment		3585.1	5.6	5.4	16.3	-22.2	12.5	**-12.6**	**9.0**	**1.9**
Exports (goods and services)		132592.1	208.8	5.4	0.7	0.5	0.8	**2.5**	**3.0**	**1.8**
Imports (goods and services)		109733.3	172.8	5.8	0.6	-0.3	0.9	**2.1**	**3.0**	**1.9**
GNI (GDP deflator)		39813.8	62.7	1.2	3.1	1.9	0.7	**5.9**	**7.2**	**5.0**
Contribution to GDP growth:		Domestic demand		1.9	2.4	0.5	2.3	**-2.3**	**3.4**	**2.7**
		Inventories		0.0	-1.1	0.9	-0.2	**-0.4**	**0.0**	**0.0**
		Net exports		1.0	0.4	1.6	0.2	**1.4**	**1.1**	**0.6**
Employment				2.9	3.4	3.7	3.6	**2.0**	**1.9**	**2.0**
Unemployment rate (a)				4.8	5.5	5.6	5.6	**6.8**	**7.4**	**7.3**
Compensation of employees / head				2.7	3.0	3.3	1.7	**-0.7**	**2.4**	**2.2**
Unit labour costs whole economy				2.7	4.6	3.9	3.0	**2.6**	**-0.2**	**0.9**
Real unit labour cost				0.1	2.8	1.3	-0.4	**0.3**	**-2.3**	**-1.5**
Saving rate of households (b)				:	:	:	:	**:**	**:**	**:**
GDP deflator				2.6	1.7	2.5	3.4	**2.3**	**2.2**	**2.5**
Harmonised index of consumer prices				2.2	2.1	2.0	1.6	**0.0**	**2.1**	**1.6**
Terms of trade goods				0.8	-1.4	0.4	-1.0	**-0.4**	**0.0**	**-0.1**
Trade balance (goods) (c)				-4.2	-2.0	-2.0	-3.1	**-3.3**	**-3.0**	**-2.9**
Current-account balance (c)				3.3	-0.9	0.0	-1.1	**6.5**	**7.9**	**8.6**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				2.8	-1.5	-0.7	-1.7	**5.8**	**7.3**	**8.0**
General government balance (c)				1.4	1.3	3.0	2.4	**-4.1**	**-0.3**	**-0.1**
Cyclically-adjusted budget balance (d)				1.5	1.7	3.2	2.8	**-1.9**	**1.1**	**1.1**
Structural budget balance (d)				1.9	1.7	3.2	2.8	**-1.9**	**1.1**	**1.1**
General government gross debt (c)				14.8	22.3	21.0	22.0	**24.9**	**27.0**	**26.8**

(a) Eurostat definition. (b) gross saving divided by adjusted gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.