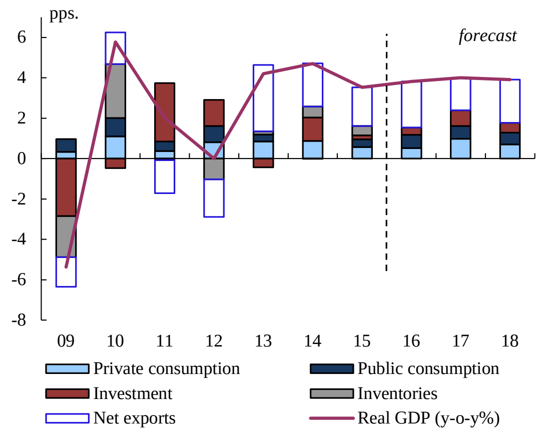
16. LUXEMBOURG

Strong broad-based growth

Luxembourg's growth is expected to remain close to 4% throughout the forecast horizon. In line with the recovery in oil prices, inflation is projected to rebound. Employment growth will remain solid, while unemployment is expected to decrease only marginally. Even after a tax reform, that will decreased the tax burden overall, public finances are projected to remain sound.

After a relatively weak performance in the first quarter of 2016, closely related to the negative evolution of financial markets at the beginning of the year, economic activity gained momentum in the following two quarters, supported by a sharp improvement in the net exports of services, particularly financial services. Based on available soft and hard indicators signalling a surge in the confidence of both households and corporations, growth is likely to come in strong in the last quarter of the year. Over 2016 as a whole, Luxembourg's economic growth is expected to have slightly accelerated to 3.8% from 3.5% in 2015.

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



In 2017, GDP growth is expected to rise to 4.0%. An improvement in household disposable income should support private consumption expansion growth, as disposable incomes benefit from the tax-decreasing reform that took effect at the start of the year. Favourable financial conditions and strong employment prospects should also outweigh the impact of higher oil prices. Finally, household purchasing power should also benefit from indexed wage increases, which took place at the beginning of the year. Favourable lending conditions are projected to continue boosting investment. In particular, construction is expected to remain robust over the forecast period, supported both by household and public sector investment plans, the latter being engaged with the execution of large public infrastructure projects. In line with a recovery in capacity utilisation rates and the accommodative credit stance, an improvement in equipment investment is also expected. In light of the high share of import content in investment, a slight decrease in the growth contribution of net exports is expected in 2017.

In 2018, as the impact of the tax reform on households' purchasing power is set to fade away, private consumption is expected to lose some momentum. Economic growth is then projected to be sustained by a recovery in the external environment, especially the euro area, and growth is projected to ease to 3.9%.

Job creation remains robust

In 2016, employment growth is expected to have accelerated to 3.0% from 2.6% in 2015. In line with the buoyant economic outlook, job creation is projected to remain robust both in 2017 and 2018. As non-residents are likely to benefit more than residents, the labour market developments will prove to be insufficient to substantially lower the unemployment rate, which will gradually decrease to 6.2% by the end of the forecast horizon from 6.5% in 2015. The unemployment rate is then forecast to stabilise at that level by the end of the forecast horizon.

A rebound in inflation

Headline HICP inflation turned out flat in 2016, mainly because of the pronounced drop in oil prices. As oil prices bottomed out at the beginning of 2016 and since then have progressed substantially, a rebound in inflation is projected in 2017 and in 2018, respectively to 2.0% and 2.1%. The automatic indexation of wages, triggered at the start of 2017, is expected to be triggered again in the course of next year. Increases in the headline inflation are then expected to gradually push up core inflation, which is projected to increase to 1.6% in 2017 and to hit 2.1% in 2018.

Public finances remain sound

In 2016, the general government balance is expected to post a surplus of 1.6% of GDP. Low inflation combined with the incremental impact of saving measures adopted with the 2015 budget will help to contain expenditure, in spite of the high level of public investment maintained by the authorities. At the same time, revenues remained firm in line with the robust economic growth projected.

The general government balance is then expected to shrink to a small surplus of 0.2% of GDP in 2017, mostly due to the impact of the tax reform that took effect at the beginning of the year. In addition to repealing the temporary budgetary levy introduced in 2015, tax brackets were revised to become less progressive, while two new tax brackets for high revenues were introduced. In addition, tax credits related to house purchases were increased. Moreover, the corporate income tax rate was reduced from 21% to 19% in 2017 and to 18% from 2018. A more favourable tax treatment for small enterprises was also introduced. All in all, the tax reform is expected to shave revenues by an estimated 0.8% of GDP. Finally, due to a change in legislation, the share of VAT revenues held by Luxembourg on e-commerce related transactions will decline to 15% from 30%.

Based on a no-policy-change assumption, the surplus of the general government balance is projected to edge up to 0.3% of GDP in 2018.

The general government's structural surplus, mirroring the drop in the headline balance and in the light of the closing of the output gap towards the end of the forecast period, is expected to narrow by about 2 pps. of GDP over the forecast horizon, still remaining in positive territory.

Luxembourg debt-to-GDP ratio is expected to decrease from 22.1% of GDP in 2015 to 21.0% of GDP in 2016. It is then projected to increase to 23.5% of GDP over the forecast horizon in spite of the regular primary surplus. The surplus of the social security sector cannot be used to finance the deficit of the central government, which is projected to widen from 2017 onward as for effect of the tax reform and thus has to be financed with new debt issuance.

Table II.16.1:

Main features of country forecast - LUXEMBOURG

		2015		Annual percentage change						
	mio EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP		51216.2	100.0	3.8	4.2	4.7	3.5	**3.8**	**4.0**	**3.9**
Private Consumption		15702.8	30.7	2.9	2.6	2.7	1.8	**1.7**	**3.3**	**2.4**
Public Consumption		8553.9	16.7	4.0	1.9	0.0	2.3	**4.0**	**3.9**	**3.4**
Gross fixed capital formation		9719.0	19.0	4.9	-2.1	6.0	1.0	**1.9**	**4.2**	**2.7**
of which: equipment		3349.4	6.5	8.1	-6.2	6.1	-12.7	**1.1**	**5.4**	**2.1**
Exports (goods and services)		120658.0	235.6	6.3	6.3	12.1	12.8	**3.8**	**4.7**	**4.9**
Imports (goods and services)		103749.5	202.6	6.6	5.3	13.1	14.0	**3.3**	**4.7**	**4.7**
GNI (GDP deflator)		33335.1	65.1	2.6	0.2	4.4	0.6	**6.5**	**3.4**	**4.4**
Contribution to GDP growth:	Domestic demand			2.7	0.8	2.0	1.1	**1.5**	**2.4**	**1.8**
	Inventories			0.1	0.2	0.5	0.5	**0.0**	**0.0**	**0.0**
	Net exports			1.1	3.3	2.1	1.9	**2.3**	**1.6**	**2.1**
Employment				3.4	1.8	2.6	2.6	**3.0**	**2.9**	**2.7**
Unemployment rate (a)				3.8	5.9	6.0	6.5	**6.3**	**6.2**	**6.2**
Compensation of employees / head				3.0	2.3	2.6	0.9	**0.4**	**3.1**	**2.4**
Unit labour costs whole economy				2.5	0.0	0.5	0.1	**-0.3**	**2.0**	**1.1**
Real unit labour cost				0.2	-1.3	-1.0	-0.3	**-1.9**	**0.2**	**-1.0**
Saving rate of households (b)				-	-	-	-	**-**	**-**	**-**
GDP deflator				2.3	1.3	1.5	0.4	**1.6**	**1.8**	**2.2**
Harmonised index of consumer prices				2.5	1.7	0.7	0.1	**0.0**	**2.0**	**2.1**
Terms of trade of goods				0.3	-0.9	1.1	2.0	**0.2**	**-0.3**	**0.2**
Trade balance (goods) (c)				-6.9	-1.0	1.3	3.4	**3.5**	**3.0**	**3.0**
Current-account balance (c)				8.8	5.6	5.1	5.2	**5.3**	**4.9**	**5.8**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)				-	3.8	2.9	4.1	**5.8**	**5.5**	**6.4**
General government balance (c)				2.0	1.0	1.5	1.6	**1.6**	**0.2**	**0.3**
Cyclically-adjusted budget balance (d)				1.9	2.6	2.5	2.5	**2.2**	**0.4**	**0.3**
Structural budget balance (d)				-	2.6	2.5	2.3	**2.2**	**0.4**	**0.3**
General government gross debt (c)				10.7	23.5	22.7	22.1	**21.0**	**23.1**	**23.5**

(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.