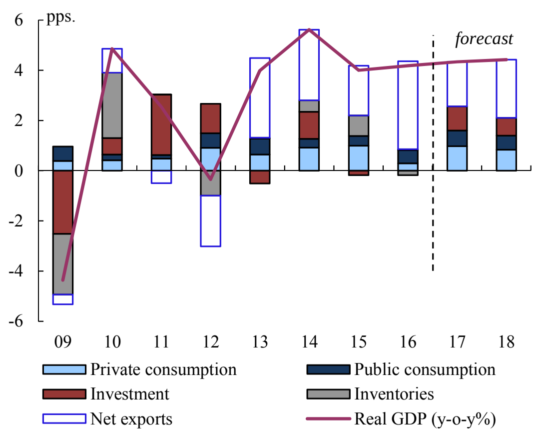
16. LUXEMBOURG
Strong broad-based growth

Luxembourg's economy is expected to grow above 4% in 2017 and 2018. The recovery of oil prices along with additional domestic factors, are expected to keep inflation close to 2%. Employment growth will remain solid, with growth of resident employment accelerating, while unemployment is expected to fall further. Public finances are projected to remain sound in spite of the tax-decreasing reform.

In the last quarter of 2016, economic activity continued to show strong momentum supported by a steady improvement in net exports of services, in particular in the financial area and a recovery of domestic demand. Over 2016 as a whole, Luxembourg's economy growth is estimated to have slightly accelerated to 4.2% after 4.0% in 2015.

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



Solid growth ahead

In 2017, all indicators bode well for the strong momentum to continue. In particular, a rebound in domestic demand is projected to kick in and contribute to a more balanced growth. Notably, private consumption is projected to surge in line with the significant improvement in households' disposable income. Specifically, households' purchasing power is going to benefit from the reduction in tax payments as induced by the tax reform and from the implementation of the automatic indexation of wages, both of which took effect at the start of the year. While employment prospects remain positive, households are expected to consume a large share of this additional income. In turn, this favourable economic outlook is projected to foster investment growth. Equipment investment is expected to recover on the back of the positive environment, historically high levels of capacity utilisation and the still accommodative credit stance. At the same time, construction investment is estimated to remain robust over the forecast period, supported by both private housing investment and the engaged public investment plans, including the execution of large infrastructure projects. Contribution to growth from net exports is projected to remain substantial even if a slight drop is expected, partly due to the large import-content of investment. All in all, GDP growth is foreseen to accelerate slightly to 4.3% in 2017.

In 2018, economic growth is projected to slightly accelerate to 4.4%, supported by the recovery of the external environment, especially in the euro area, offsetting the projected slowdown in domestic demand, as the impact of the tax reform on consumption fades away.

Job creation remains robust

In 2016 employment growth accelerated to 3.0% from 2.6% in 2015. The buoyant economic environment will support job creation, which is projected to remain robust both in 2017 and 2018. While employment growth of non-residents remains higher than residents', a steady acceleration of resident employment growth is taking place, helping to curb the unemployment rate, which peaked at 6.5% in 2015, and is forecast to gradually fall throughout the forecast horizon and set at 6.0% in 2018.

Sustained inflation upturn

Headline HICP inflation was zero on average in 2016, strongly affected by oil prices, which bottomed out at the beginning of last year. Their subsequent surge gave a hefty spur on inflation as from the first quarter of 2017, which is foreseen to linger over the year. In addition, second round effects from the concurrent wage indexation, are expected to add some pressure on prices along the forecasts horizon. Accordingly, core inflation is projected to gradually increase to 1.3% in 2017 and to hit 1.9% in 2018 overshooting headline inflation.

Public finances remain sound

In 2016, the general government balance recorded a surplus of 1.6% of GDP. The subdued evolution of inflation-linked outlays combined with the incremental impact of saving measures adopted with the 2015 budget helped to contain expenditure, in spite of a high level of public investment maintained by the authorities.

In 2017, the general government balance is expected to shrink to a small surplus of 0.2% of GDP. Growth of government expenditure is expected to accelerate after the triggering of the automatic indexation of wages as a large part of its outlays is linked to inflation. Public investment is projected to further expand while the wage bill will grow faster as for the impact of the implementation of the recent wage agreement in the public sector.

At the same time, revenues will suffer after the tax reform that took effect at the beginning of the year. Amongst other things the reform repealed the temporary budgetary levy introduced in 2015 and it revised the tax brackets to become less progressive for lower income, 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 to 19% from 21% and a more favourable tax treatment for small enterprises introduced. All in all, the reform is expected to shave revenues by an estimated 0.8% of GDP. Finally, additional revenues, equivalent to 0.3% of GDP, will be lost, due to the decline from 30% to 15% in the share of VAT revenues held by Luxembourg on e-commerce related transactions. Based on a no-policy change assumption, the surplus of the general government balance is projected to slightly improve 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 substantially diminish in 2017 and 2018, remaining however in positive territory.

Luxembourg's debt-to-GDP ratio decreased to 20.0% in 2016. In spite of a regular primary surplus, it is set to increase to 22.3 % over the forecast horizon, as the surplus of the social security sector cannot be used to finance the deficit of the central government, which has then to be financed with 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	52339.7	100.0	3.6	4.0	5.6	4.0	**4.2**	**4.3**	**4.4**
Private Consumption	15658.9	29.9	2.5	2.0	2.9	3.3	**1.0**	**3.3**	**2.9**
Public Consumption	8643.2	16.5	3.5	3.6	2.0	2.4	**3.2**	**3.9**	**3.4**
Gross fixed capital formation	9503.2	18.2	4.9	-2.5	5.6	-0.9	**0.2**	**5.4**	**4.0**
of which: equipment	3238.1	6.2	8.4	-10.5	6.4	-17.4	**-14.4**	**6.1**	**4.0**
Exports (goods and services)	118870.6	227.1	6.7	6.1	11.8	11.1	**4.9**	**5.6**	**5.9**
Imports (goods and services)	100710.0	192.4	7.2	5.2	12.5	12.1	**4.0**	**5.7**	**5.8**
GNI (GDP deflator)	34461.8	65.8	2.0	0.2	5.9	1.6	**2.7**	**3.8**	**4.5**
Contribution to GDP growth:	Domestic demand		2.5	0.8	2.3	1.2	**0.9**	**2.6**	**2.1**
	Inventories		0.0	0.0	0.5	0.8	**-0.2**	**0.0**	**0.0**
	Net exports		1.1	3.2	2.8	2.0	**3.5**	**1.8**	**2.3**
Employment			3.4	1.8	2.6	2.6	**3.0**	**3.1**	**3.1**
Unemployment rate (a)			3.8	5.9	6.0	6.5	**6.3**	**6.1**	**6.0**
Compensation of employees / head			3.0	2.7	2.1	1.7	**0.4**	**3.0**	**1.9**
Unit labour costs whole economy			2.8	0.5	-0.8	0.3	**-0.7**	**1.8**	**0.6**
Real unit labour cost			0.2	-0.9	-2.4	-0.4	**-0.1**	**-0.6**	**-1.7**
Saving rate of households (b)			-	-	-	-	**-**	**-**	**-**
GDP deflator			2.6	1.5	1.6	0.7	**-0.6**	**2.4**	**2.3**
Harmonised index of consumer prices			2.5	1.7	0.7	0.1	**0.0**	**2.4**	**1.8**
Terms of trade of goods			0.1	-1.3	0.3	0.3	**0.3**	**0.0**	**-0.1**
Trade balance (goods) (c)			-6.9	-0.1	1.5	2.7	**3.9**	**3.7**	**3.6**
Current-account balance (c)			8.7	5.5	5.0	5.1	**4.7**	**4.5**	**5.0**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			8.3	3.8	2.9	4.0	**3.4**	**5.0**	**5.5**
General government balance (c)			2.0	1.0	1.4	1.4	**1.6**	**0.2**	**0.3**
Cyclically-adjusted budget balance (d)			1.9	3.0	2.5	2.3	**2.0**	**0.4**	**0.1**
Structural budget balance (d)			-	3.0	2.5	2.2	**2.0**	**0.4**	**0.1**
General government gross debt (c)			10.7	23.4	22.4	21.6	**20.0**	**22.0**	**22.3**

(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.