



Summary

Economic growth was very disappointing in 2011 thanks to the weakening of global activity and the sovereign debt crisis that hampered the financial sector's performance. Going forward, Luxembourg's growth performance is unlikely to return to the lofty levels witnessed earlier this decade.

The country's fiscal position remains one of its few strengths. That said, the combination of an ageing population and one of the most generous pension systems in the world weakens Luxembourg's ability to sustain deficits in the long term. Fiscal contingencies stemming from banking sector problems is another great concern given the financial sector's massive size. Then again, we do take comfort in the fact that the sector is now restructuring and deleveraging.

Things to watch:

- Progress on pension reform
- Financial market tensions in the Eurozone and the pace of deleveraging in the region

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Luxembourg			
National facts		Social and governance indicators rank / total	
Type of government	Constitutional Monarchy	Human Development Index (rank)	25 / 187
Capital	Luxembourg	Ease of Doing Business Index (rank)	50 / 183
Surface area (thousand sq km)	3	Index of Economic Freedom (rank)	13 / 179
Population (millions)	0.5	Corruption Perceptions Index (rank)	11 / 183
Main languages	Luxembourgish	Press Freedom Index (rank)	6 / 178
	German/French (admin.)	Gini index (income distribution)	30.76025
Main religions	Roman Catholic (87%)	Population below \$1.25 per day (PPP)	n.a.
	Other (13%)		
		Foreign trade 2010	
Head of State (president)	Grand Duke Henri	<i>Main export partners (%)</i> <i>Main import partners (%)</i>	
Head of Government (prime-minister)	Jean-Claude Juncker	Germany	31
Monetary unit	EUR	France	22
		Belgium	17
		UK	13
		Belgium	38
		France	31
		China	14
		France	11
Economy 2011		Main export products (%)	
<i>Economic size</i> bn USD % world total		<i>Main import products (%)</i>	
Nominal GDP	60 0.09	Machinery and transport equipment	56
Nominal GDP at PPP	43 0.05	Food, drinks and tobacco	8
Export value of goods and services	95 0.43	Chemicals and related products, n.e.s.	8
IMF quatum (in mln SDR)	419 0.19	Raw materials	3
<i>Economic structure</i> 2011 5-year av.		<i>Main import products (%)</i>	
Real GDP growth	1.3 1.9	Machinery and transport equipment	44
Agriculture (% of GDP)	n.a. n.a.	Mineral fuels, lubricants, and related materi:	13
Industry (% of GDP)	n.a. n.a.	Food, drinks and tobacco	11
Services (% of GDP)	n.a. n.a.	Chemicals and related products, n.e.s.	11
<i>Standards of living</i> USD % world av.		<i>Openness of the economy 2011</i>	
Nominal GDP per head	126474 1173	Export value of G&S (% of GDP)	158
Nominal GDP per head at PPP	89679 727	Import value of G&S (% of GDP)	111
Real GDP per head	87896 1081	Inward FDI (% of GDP)	243.2

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economy

Economic growth was still robust in 2011 (GDP up by 1.5% y-o-y after rising by 2.7% in 2010) amid weakening of global activity and the sovereign debt crisis that hampered the financial sector's performance. However, estimated growth for 2012 have recently been revised downward by the European Commission, to 0.7% thanks to a weaker global economic backdrop.

Clearly, Luxembourg's growth performance is unlikely to return to the lofty levels witnessed earlier this decade. The country's financial-sector based growth model will be challenged by forthcoming changes to the international regulatory framework. The financial sector will also continue facing headwinds from ongoing global deleveraging. At the same time, increases in the value of managed portfolios in the investment fund industry are likely to lose steam. Another source of worry over the medium-term stems from the country's loss of international competitiveness. Rapid growth of the financial sector has hurt competitiveness by pushing up wages throughout the economy without corresponding productivity gains. This has been amplified by increases in minimum wages and automatic backward-looking wage indexation. In this regard, the government and the social partners must explore ways to limit the adverse effects of wage indexation in the short-term and eliminating them completely in a couple of years.

Luxembourg's fiscal position remains one of the country's strengths. Although the general government balance has deteriorated sharply from a surplus of 3% of GDP in 2008 to a deficit of 0.7% in 2011 (IMF's estimate), the country's public finances are no cause for concern (unlike in

most advanced countries). The estimated government's deficit for 2011 was better than budgeted (1.2%), mainly due to large pre-crisis lagged corporate tax collections. The budget for 2012 points to a deficit of 0.7% of GDP but risks are skewed to the downside as the 2012 economic performance is likely to be weaker than the budget's underlying assumption. The authorities maintain their medium-term objective of reaching a balanced budget by 2014. This is indeed desirable but the way that this is going to be achieved is not so. The brunt of the 2011 fiscal adjustment fell on public investment, with further reductions of about 0.75% of GDP on average in the next five years. The budget's tight investment envelope may harm long-term growth prospects and, therefore, cutting current expenditure should be central to fiscal efforts.

One must note that public debt-to-GDP is still very low (21% in 2011) when compared to neighbouring countries. The IMF expects the public debt ratio to rise to 35% in 2017. This means sovereign debt has further room to increase before markets start worrying about the country's public finances. That said, the combination of an ageing population and one of the most generous pension systems in the world weakens Luxembourg's ability to sustain deficits in the long term. Pension reforms are therefore of paramount importance, even taking into account the social security reserves, to ensure long-term fiscal sustainability. Ageing-related expenditure in Luxembourg are set to double to 40% of GDP by 2060, according to official projections. Meanwhile, pension reserves are anticipated to be depleted by about 2035. On a positive note, reforms of the social security system (the so-called 'implicit debt') are currently being debated, and the government plans the first legislation related to pension reform to be passed within the course of the year and to enter into force in January 2013. This is indeed a development that merits close monitoring in the coming quarters.

The banking sector

Fiscal contingencies stemming from banking sector problems is another great concern given the financial sector's size (representing about one-fourth of Luxembourg's GDP, one-third of its tax revenues, and one-eighth of its labor force) and the lack of a well-defined framework for cross-border bank resolution and burden-sharing mechanisms. Renewed problems in sovereign debt markets or concerns on the financial soundness of parent banks could very well be transmitted into the domestic banking system. Having said that, we do take comfort in the fact that the sector is now restructuring and deleveraging. Bank balance sheets have contracted in both 2010 and 2011. In aggregate, the IMF reckons that bank capitalization has increased and appears broadly adequate though unevenly distributed across banks. What's more, the fact that the overwhelming proportion of credit is granted by banks that are subsidiaries of foreign institutions (90% of total bank assets are foreign-owned) means the sector as a whole only poses a moderate risk as a contingent liability to the state. It should be noted, however, that the direct involvement of the state in the Belgian-led bailout of Fortis Bank in 2008 (costing it USD 2.5bn or 6% of GDP) implies that the country is not always fully insulated.

Luxembourg							
Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
<i>Key country risk indicators</i>							
GDP (% real change pa)	6.6	0.8	-5.3	2.7	1.3	-0.8	0.5
Consumer prices (average % change pa)	2.3	3.4	0.4	2.3	3.4	2.6	2.7
Current account balance (% of GDP)	10.1	5.2	6.3	7.7	6.1	5.4	4.2
<i>Economic growth</i>							
GDP (% real change pa)	6.6	0.8	-5.3	2.7	1.3	-0.8	0.5
Gross fixed investment (% real change pa)	12.6	-0.1	-14.5	0.0	14.0	-2.0	2.0
Private consumption (real % change pa)	3.3	3.4	1.1	2.1	1.0	0.8	0.7
Government consumption (% real change pa)	3.8	1.7	4.9	3.0	1.0	1.0	1.0
Exports of G&S (% real change pa)	9.1	4.0	-10.9	2.8	3.5	-0.4	0.8
Imports of G&S (% real change pa)	9.3	5.6	-12.0	4.6	2.9	0.2	1.2
<i>Economic policy</i>							
Budget balance (% of GDP)	3.9	3.8	-0.9	-1.7	-0.6	-1.1	-1.6
Public debt (% of GDP)	4	8	17	17	17	18	19
nt transfers: balance, USD	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
M2 growth (% change pa)	8	-2	-18	6	1	3	2
Consumer prices (average % change pa)	2.3	3.4	0.4	2.3	3.4	2.6	2.7
Exchange rate LCU to USD (average)	3.7	3.7	3.7	3.7	3.7	n.a.	n.a.
Recorded unemployment (%)	4.4	4.4	5.7	6.0	5.9	4.8	4.9
<i>Balance of payments (mln USD)</i>							
Current account balance	5215	3040	3307	4122	3700	3000	2300
Trade balance	-4801	-6692	-4588	-5443	-6400	-6700	-6400
Export value of goods	18406	21371	15384	16661	19900	17900	18700
Import value of goods	23206	28063	19972	22104	26270	24540	25080
Services balance	27312	29444	25080	30090	34700	30600	29000
Income balance	-15282	-16970	-15780	-19625	-23700	-20000	-19300
Transfer balance	-2014	-2742	-1403	-900	-1000	-900	-900
Net direct investment flows	-75466	-27735	-22397	22739	43950	21560	-7600
<i>External position (mln USD)</i>							
International investment position	52730	52070	53060	51550	n.a.	n.a.	n.a.
Total assets	6199270	5561720	6217250	6560380	n.a.	n.a.	n.a.
Total liabilities	6146540	5509650	6164190	6508830	n.a.	n.a.	n.a.
<i>Key ratios for balance of payments, external solvency and external liquidity</i>							
Trade balance (% of GDP)	-9.3	-11.5	-8.8	-10.2	-10.6	-12.1	-11.6
Current account balance (% of GDP)	10.1	5.2	6.3	7.7	6.1	5.4	4.2
Inward FDI (% of GDP)	377.0	176.1	397.6	388.8	243.2	206.8	211.2
International investment position (% of GDP)	102.6	89.8	101.8	96.4	n.a.	n.a.	n.a.

Source: EIU

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