Growth continues but clouds of uncertainty gather*

As 2018 draws to a close, the economic situation in Luxembourg remains positive. However, growth forecasts have been revised downwards notably in conjunction with the deterioration in the global economic environment. GDP growth in Luxembourg should therefore rise to 3% per year, both this year and next year.

Economic growth for 2016 and 2017 has been revised downwards, with technical phenomena having affected performance in certain sectors, despite a positive economic climate. Estimates for the first two quarters of 2018 nonetheless indicate dynamic growth close to 3% year-on-year. Although confidence among economic stakeholders dropped substantially in 2018, morale among businesses and households in Luxembourg seems to be holding up – which is a positive sign.

The current European slowdown, which is set to continue into 2019, will likely lead to lower demand for Luxembourg exports. Activity in financial services is also set to suffer from the renewed fall in equity markets. GDP growth for this year has thus been revised downward. It is now expected to be 3% per year over this period, against 4% per year as predicted last spring. The margin of error for this forecast is much wider than usual, in particular because it is difficult to anticipate the future development of technical phenomena that have affected growth over the last two years, but also due to the uncertain impact of international trade tensions.

Increased pressure on inflation and wages

Under the impact of rising energy prices and the wage indexation adjustment paid out in August, inflation has picked up in recent months. Following the dissipation of the downward effect from vouchers for childcare services (chèques-services), the inflation rate rises temporarily above 2% from November. The projected increase in inflation, from 1.6% in 2018 to 1.9% in 2019, is based on underlying inflation, while oil prices have started to stall.

Wages temporarily slowed at the start of the year, with the effects of the wage agreements and the 2017 wage indexation adjustment waning. The last adjustment in August 2018 and the adjustment scheduled for the fourth quarter of 2019 should help to boost them. STATEC therefore expects the average wage bill to grow by almost 1.9% in 2018 and 2.6% in 2019.

Slight downturn expected in the labour market in 2019

Employment growth is peaking in Europe, but has remained very dynamic in Luxembourg. Job prospects and job offers remained high in the third quarter, but a long-term slowdown is expected in both Europe and the Grand Duchy. Employment growth should remain high enough, however, to keep pushing down unemployment into 2019.

Public finances boosted by extremely dynamic receipts

Tax receipts increased sharply over the first 11 months of 2018, rising 10.5% over one year. All the main categories of tax contributed to this rise. The strongest contribution came from the recovery in taxes levied on households, significantly stymied last year by the tax reform. All in all, public receipts are set to grow over 7% in 2018 before slowing slightly in 2019 (to +5.4%).

As with the 2018 receipts, public expenditure forecasts have also been revised upward, for both this year and next. However, if policy remains unchanged, STATEC predicts a slight slowdown in expenditure compared to 2017, to +5.9% in 2018 and +5.3% in 2019. With no State budget as yet for 2019, these adjustments are based on observed and projected spending trends and in the macroeconomic fundamentals underlying spending, both nominal and real. Overall, these trajectories should see a continuing improvement in the public balance. This is forecast to be close to 2% of GDP in 2018 and 2019, up from 1.4% last year.

* Forecast published in the NDC 2-18 on 4.12.2018
International

**EURO ZONE: GDP AND THE PMI**

Sources: Eurostat, Markit Economics

**Euro zone: growth should remain weak in Q4**

On the whole, business and consumer surveys in the euro zone continue to point towards a deterioration in sentiment at the end of 2018. The Purchasing Managers’ Index (PMI) fell to 51.3 points in December, its lowest level for 49 months, with a sharp decline for business services, in comparison to November. The level posted by the indicator for the whole of the fourth quarter corresponds to a euro zone GDP growth rate of close to 0.2% over one quarter (i.e. identical to the figure for the third quarter). The survey reveals concerns about the global political climate [trade wars, Brexit, political tensions in the euro zone], problems in the automobile industry and the impact of the “gilets jaunes” (yellow vests) in France. Furthermore, the Bank of France recently cut its fourth quarter GDP forecast in half to 0.2% (as compared to 0.4% previously), citing the impact of the protests being felt “in most sectors”. In Germany, the ZEW indices [forecasts for Germany and the euro zone] rose strongly in December; however, the IFO survey continues to point to a fall in projections.

**Financial sector 1/2**

**EUROPEAN STOCK-MARKET INDICES**

Source: Macrobond

**Slump continues for European equities**

The decline in the European stock market index has endured; it has fallen another 9% since the start of October (-12% since January). The spread between American and European interest rates continues to increase, leaving bank stocks less and less attractive to investors, dragging the whole stock market index lower. Elsewhere, the difficult negotiations surrounding Brexit and the Italian budget, coupled with prolonged trade tensions between China and the United States are increasingly weighing on the minds of investors and impinging on stocks markets.

This fall in the value of European equities will ultimately lead to a 3% pullback in the stock market in 2018. If prices stabilise at current levels, the decline would then be 9.2% on average in 2019, a more pessimistic outlook than originally set out in the last *Note de conjoncture* (-4.5%), thus sending a negative signal in terms of the performance of the financial sector. If prices rose at their historical pace of +0.3% per month in 2019, the decline would be 8.2% and would remain larger than expected in the NDC 2-18.

**Financial sector 2/2**

**NET ASSETS OF UNDERTAKINGS FOR COLLECTIVE INVESTMENT**

Source: CSSF

**Investment funds debilitated by stock markets**

In October, Luxembourg undertakings for collective investment (UCIs) were affected by the pullback in stock markets and their net assets have decreased 1.7% over one month. Whatever their geographical origin, the equities held have mainly depreciated compared to the previous month (except those from Latin America), which contributed to pushing the value of assets under management (AuM) down by 2.3 percentage points over one month.

The increase in net investments has made it possible to limit the damage (contributing 0.6 percentage points over a month), but this increase is mainly witnessed in money market funds and, according to the Commission de surveillance du secteur financier (CSSF), partly reflects cross-border mergers of foreign funds into Luxembourg funds.

Over the first ten months of the year, investment funds posted AuM growth of 7.2% over one year (as compared to 12% on average over the last 5 years).
Consumer prices

FOOD PRICES - CONTRIBUTIONS TO HEADLINE INFLATION

Vegetables fuel inflation

Food prices were a significant contributor to headline inflation in 2017. Poor harvests at the start of the year in southern Europe led to a surge in the price of fruit and vegetables. Higher prices for meat, fish, cereals and soft drinks exerted additional pressure on inflation in 2017. Since the end of 2017, food inflation has subsided, partly as a result of soaring vegetable prices a year earlier.

However, this respite was only temporary, with food inflation rising to 3.0% over one year in November 2018 (compared to 2.8% over 2017 as a whole and 2.3% on average since 2005). Prices of fresh vegetables and potatoes soared as a result of the drought in Europe (+20% and +9% respectively over one year in November). This increase, experienced across Europe, should lead to higher prices for processed foods which are based on these fresh products. In November, food inflation contributed almost 0.4 percentage points to total inflation (+2.3% over one year).

Labour market 1/2

TRENDS IN DOMESTIC PAID EMPLOYMENT (IN %)

Slowdown in paid employment

In the third quarter of 2018, paid employment rose 0.7% over one quarter, compared to +1% over the three previous quarters. This slight increase is relatively general in scope and can be observed in business services [in particular in temporary employment] as well as in trade, hotel and catering and manufacturing. However, the latter, at -0.2% over a quarter, was the only sector to post a fall in the third quarter.

The slowdown in employment was experienced in all euro zone countries [+0.2% over one quarter in Q3, following +0.4% in Q2] and had already been projected in STATEC’s and the European Commission’s autumn forecasts. In fact, this trend should continue over the coming quarters but should not prevent unemployment from falling further. Therefore, the fall in unemployment at the end of 2018 (at 5.2% in November and 5.5% only three months ago), points towards a very favourable climate on the Luxembourg labour market, which remains one of the most dynamic in Europe.

Labour market 2/2

PARTIAL UNEMPLOYMENT APPLICATIONS GRANTED

Partial unemployment applications rise

In the last quarter of 2018, an average of 13 companies were granted approval to work on a reduced-time basis per month, almost double the number posted at the beginning of the year [seven in the first quarter]. Consequently, close to 1,000 people now receive State aid as a result of this measure. This figure is still a long way from the 7,000 people who benefited from this scheme in 2009 but, nonetheless, the reversal is present.

However, the majority of the requests display a rather non-cyclical nature, such as supply problems, particularly due to the exceptionally low level of the Rhine following the drought or difficulties related to inefficiency in the automotive industry. The slowdown in employment in the Luxembourg manufacturing sector [+1.1% growth over one year in the third quarter of 2018, following +1.7% in the second quarter] could therefore continue to the end of 2018/early 2019, despite still favourable employment prospects of industrialists up until November.
Car registrations experienced a surge during the summer months, before the entry into force of the new European WLTP certification standards on 1 September 2018. Subsequently, the fervour has largely subsided - from September to November, registrations posted a decline of around 20% compared to the previous year (-13% for the euro zone). Over the year as a whole [at the end of November], registrations ultimately posted a modest gain of 0.5% as compared to 2017 (+ 1.9% for the euro zone). In addition to the new standards, low water levels as a result of the drought have hindered vehicle deliveries.

This affected automobile production and led to significant storage scenarios. Due to the temporary nature of this phenomena, the subsequent expected upturn has not yet occurred, perhaps because there are also problems in terms of demand [including a decline in extra-EU orders]. The construction of motor vehicles in the euro zone, especially in Germany, was evidently higher in September and October, but remains about 5% lower than in the first half of 2018.