



Much at stake in the fight against inflation

In an environment characterised by persistent inflationary pressures and restrictive monetary policies, the growth in economic activity in Luxembourg should remain moderate in 2023 and 2024, while the government balance should deteriorate considerably.

Uneven growth in the euro area at the start of 2023

The international environment remains fraught by high pressure on consumer prices. Global inflation is certainly trending downwards. However, at present, this decline is mainly due to the fall in energy prices.

Monetary authorities in many countries remain determined to reduce underlying inflationary pressures and interest rates have been increased rapidly and sharply. In the euro area, this increase has led to a reduction in the financing capacities of households and companies and has been accompanied by a tightening of credit conditions. The real estate markets in particular are beginning to feel the consequences. Moreover, the problems encountered by several banks in the United States and Europe further rocked the markets, worried about the potential vulnerability of certain actors in the financial sector.

After activity stagnated at the end of 2022, the euro area returned to growth in the 1st quarter of 2023, but this progression appears to be poorly balanced between the different Member States and sectors of activity. Overall, activity growth should remain moderate in 2023 and 2024. Inflationary trends will be decisive for the trajectory of activity. By proving more persistent than expected, it could even lead to a slight recession in the euro area next year.

Luxembourg's economy sluggish in 2023 and 2024

2022 ended with a marked decline in Luxembourg's GDP. This downturn in Q4 was mainly due to the result of the financial sector. It should be noted that this was not the outcome of a generalised trend in the sector, but of some isolated phenomena. However, other market sectors also experienced less dynamic growth over the same period. Household consumption also fell back sharply.

At the beginning of 2023, manufacturing and in particular the construction industry remained on a downward trend. Construction has been affected by the reversal that has cast a shadow over the real estate market – decline in sale prices, building permits, transactions and loans – and which has coincided with the sharp hike in interest rates. In non-financial services, certain activities are recovering in Q1, but not as markedly in Luxembourg as in the euro area as a whole.

Due mainly to the aforementioned decline in GDP in Q4 2022, activity in Luxembourg should register a slight increase this year (+1.5%), which should strengthen to +2.5% in 2024. Projected growth appears moderate

compared to the historical dynamic, despite the support resulting from the measures adopted at the tripartite meetings. Several downside risks are also weighing on this forecast, in particular the future direction of inflation.

Sticky inflationary pressures

The start of 2023 was marked by a fall in inflation in Luxembourg and the euro area, reflecting a less unstable economic environment than in 2022. Energy market tensions in Europe are easing and global supply chains are becoming more fluid. This is favouring a reduction in inflation, although the latter is not yet widespread. Core inflation thus remained high in the Grand Duchy and in the euro area at the beginning of spring.

Since the start of the year, food prices have hit all-time highs, and the two wage indexations in February and April should fuel inflation in services over the coming months. Inflation should therefore continue to maintain a certain momentum in 2023 before converging towards the 2% target at the end of 2024.

Compensation per employee slowed considerably in Luxembourg at the end of 2022. However, this movement is only temporary, with an increase expected in 2023, mainly as a result of the index brackets at the beginning of the year. For the whole of 2023, STATEC estimates that average wages should increase by 5.8%, then by 3.7% in 2024.

Labour market cooling down

The labour market is holding up quite well in the euro area at the start of 2023. Unemployment remains on a downward trend and the preliminary employment data for Q1 delivered a positive surprise.

In Luxembourg, the start of the year proved less favourable, with a confirmation of the slowdown in employment (particularly in business services and the construction sector), an upturn in unemployment and leading employment indicators that are deteriorating or remain weak. The labour shortage, as measured by the job vacancy rate, has tended to decrease since the end of 2022, but still remains historically high.

Hours worked recovered in 2021 and 2022, but not to an extent that would call into question their long-term trend, which is structurally downwards. As is the case in the euro area, Luxembourg's labour force is aging but remains comparatively younger.

Against a backdrop of sluggish economic activity, employment should slow in 2023 and 2024, but unemployment should only increase moderately.

Marked budget deficit this year and next

After a dip in Q3 2022, tax revenues have started to rise again, thanks to a recovery in corporate taxes, sustained growth in household taxes and, to a lesser extent, an increase in excise duties on oil products. High inflation accounts for 60% of revenue growth and 45% of expenditure growth in 2022.

Government finances in 2023 and 2024 will continue to be heavily dependent on inflation and its impact on activity and employment. In the baseline scenario, government revenues are expected to grow by 6.3% in 2023, buoyed by the wage bill, but limited by the less favourable evolution of subscription tax and VAT. While the wage bill and pensions will continue to boost public spending, the latter will also be impacted by support measures to counter the effects of the energy crisis (+10.3% of planned spending in 2023).

After committing around EUR 700 million in 2022, support measures are expected to reach almost EUR 1 billion in 2023 and a little less in 2024, representing just over 1% of GDP in both 2023 and 2024. As these measures have an expansive impact on activity and a dampening impact on inflation, they would ultimately allow to curb other public expenditures and thus limit the impact on government finances.

STATEC nevertheless expects a deterioration in the nominal government balance in 2023 (-1.5%) and even more so in 2024 (-2.2%), under the effect of the more pronounced slowdown in revenue than in expenditure.

Lower emissions due to the energy crisis

The European Union has proven relatively resilient in the face of the risk of energy shortages during the winter. Energy supplies were guaranteed and gas stocks remained high until the end of the winter. Member States have succeeded in reducing their energy dependence on Russia by reducing their consumption, diversifying their sources of fossil energy supply and increasing the production of renewable energies.








The record prices observed on the energy markets fell back at the end of 2022. However, this change in market prices has not led to a fall in consumer prices in Luxembourg, as suppliers' rates are still higher than the thresholds set by the government during the tripartite negotiations in 2022.

In Luxembourg, the consumption of the different types of energy decreased in 2022. According to STATEC estimates, this drop in consumption has led to a reduction in greenhouse gas emissions of 11% compared to 2021. This decrease can mainly be ascribed to lower motor fuel sales to non-residents, driven by more attractive prices in France and Belgium during the second half of 2022.

Thematic studies in this Note

- A trend reversal in real estate which is impacting construction activity
- Gas and electricity price forecasts for Luxembourg
- Decarbonisation scenarios for Luxembourg's economy

MACROECONOMIC FORECASTS

		Baseline scenario			Higher near-term inflation ¹		Faster disinflation ²	
	1995-2022	2022	2023	2024	2023	2024	2023	2024
Growth rate in % unless otherwise specified								
 Real GDP	3.1	1.5	1.5	2.5	-0.4	0.8	2.8	4.5
 Total domestic employment	3.0	3.5	2.5	2.0	1.7	1.0	3.0	3.2
 Unemployment rate (% of labour force)	4.6	4.8	5.1	5.3	5.4	5.9	4.9	4.6
 Inflation (NICP)	1.9	6.3	3.9	2.5	4.0	2.4	3.8	2.2
 Average wage costs	2.6	5.4	5.8	3.7	5.7	3.3	6.0	3.6
 Government budget balance (% of GDP)	1.6	0.2	-1.5	-2.2	-2.3	-4.0	-1.0	-1.0
 Greenhouse gas emission³	-2.2	-11.2	0.0	0.1	1.2	-4.7	0.1	1.2

Source: STATEC (2023-2024 : previsions)

1. In this unfavourable scenario, underlying inflation slows less sharply than expected and central banks respond by raising key rates further. The global economy is running out of steam, with GDP in the euro area around 1.5 percentage points below the baseline in both 2023 and 2024. Short-term rates on the EUR are expected to peak at 4.6% in the final quarter and to fall only slowly from the first quarter of 2024.

2. In this favourable scenario, inflationary pressures ease significantly in the very short term. Commodity prices fall faster than expected and cost pressures ease significantly, leading to an early reversal of key interest rates (from Q4 2023 in the euro area). The global recovery accelerates, underpinned by stronger business and consumer confidence, boosting euro area real GDP growth by more than 2 points over the two years 2023 and 2024.

3. Change 2005/2022

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