CONJONCTURE **FLASH**

July 2023

MONTHLY PUBLICATION ON THE STATE OF THE LUXEMBOURG ECONOMY

Monetary tightening continues

Successive increases in key rates have tightened financing conditions and dampened the outlook for investment and activity in the euro area. Inflation is slowing as a result of the fall in energy prices, but it remains high, due to prices of food and services, which are not particularly sensitive to monetary tightening.

At its meeting on 27 July, the Governing Council of the European Central Bank (ECB) agreed to a further interest rate hike of 25 basis points, taking key rates to their highest level in 20 years (+4.25 percentage points over the last 12 months). This monetary tightening is unprecedented in its scale and speed.

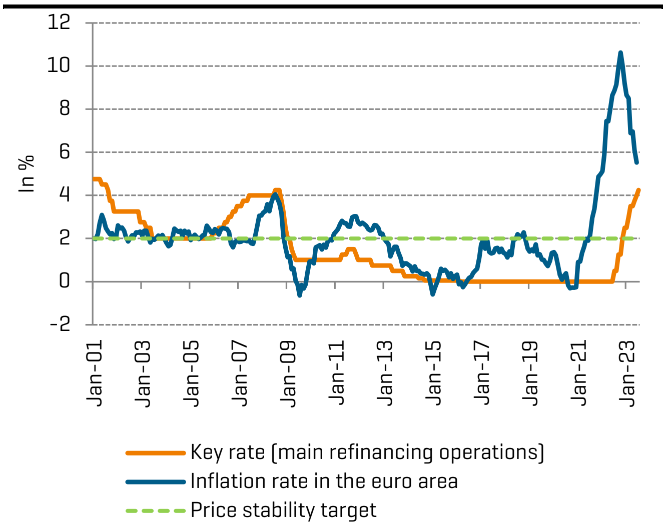
A year ago, the ECB raised interest rates for the first time in eleven years in response to soaring inflation. The surge in prices was mainly due to imbalances between global supply and demand, in a context of normalization after two years of health crisis and tensions on the energy market, amplified by the war in Ukraine. Production costs have risen as a result and these have largely been passed on to consumer prices by companies. Inflation is now mainly driven by food and service prices. While energy prices are falling and food inflation is slowing, core inflation – excluding energy and food – persists (+5.5% in June in the euro area, up from +5.3% in May). Real wages, which had fallen sharply with high inflation, are now catching up.[1]

The ECB may take a break from raising rates, but a reduction is not predicted for the moment. The current objective is to cool inflation expectations and bring the inflation rate in the euro area back towards its medium-term target of 2%.[2] However, the vigorous tightening of monetary policy is already having an impact on the real economy, while the transmission to inflation is taking much longer.[3] In addition, there are major divergences between member countries, both in terms of inflation and in terms of the budgetary support policies implemented in response to the energy crisis. While eastern European countries still display double-digit inflation rates, a quarter of the countries in the euro area (including Luxembourg) have inflation rates of 3% or less.

Tighter financial conditions weigh on activity

The ECB's announcement and the increase in key rates aim at slowing the inflation rate in the euro area by curbing demand via four main channels: financial asset prices, the exchange rate, interest rates and expectations. As soon as the initial announcements of monetary tightening were made in late 2021, bond prices surged and equity prices plummeted (+2.7 % points for the German Bund, -12% for the Euro Stoxx in 2022), deteriorating the financial income of investors.

INFLATION AND KEY INTEREST RATE IN THE EURO AREA



Sources: ECB, Macrobond

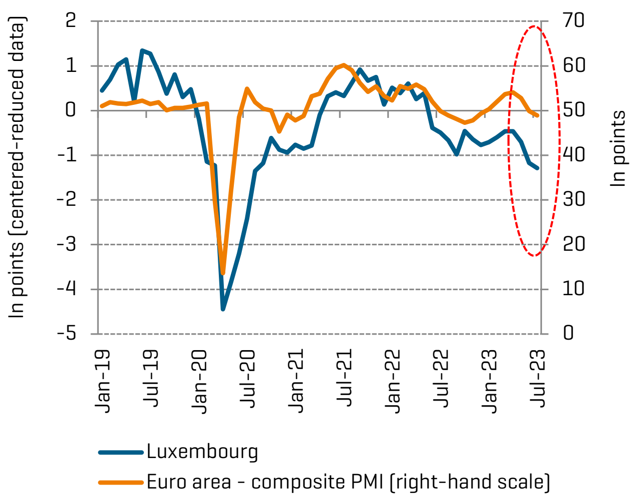
The euro area's effective exchange rate has appreciated since the first rate hike in July 2022, slowing growth of prices of imported goods. Banks have passed on the increases in key rates to interest rates on loans, causing a drastic fall in credit demand and property investments, as well as an increase in monthly payments for borrowers with variable rates.[4] Monetary tightening is already weighing on industrial activity and construction, but not yet on services. Inflation expectations among businesses and households have eased slightly but remain high. Inflation is not expected to return to 2% before 2025.[5]

In Luxembourg, average interest rates on real estate loans rose 2.3 % points over one year in May (compared with +2.5 % points in the euro area), considerably impacting the property market and construction activity. Consumer credit rates rose 2 % points, but remain among the lowest in the euro area (at 4.5% compared with an average of 7.6% in the euro area). On the other hand, rates on household term deposits are rising, which encourages savings (+2.5 % points in Luxembourg and the euro area). The transmission to rates on new loans to businesses was lower (+1.5 % points compared with +3.2 in the euro area). Despite this, the outlook for activity in industry and construction is also deteriorating in Luxembourg.

[1] In the 1st quarter of 2023, real compensation per employee was still down by 2.8% year-on-year in the euro area (after -4.1% in 2022), while in Luxembourg it increased by 2% thanks to automatic wage indexation.
[2] Originally, price stability as defined in 1998 corresponded to an increase of less than 2% in euro-area HICP (this 2% threshold was also used by the central banks of leading economies and founding countries of the euro area). In 2003, the target was defined as a rate "below, but close to 2%" to reinforce protection against the risks of deflation. The decision to set a clear and symmetrical target of 2% was taken in July 2021.
[3] Between 1.5 and 2.5 years according to several studies (see IMF, World economic outlook, April 2023).
[4] In Luxembourg, about 40% of housing loans are at variable rates.
[5] According to the latest forecasts from the OECD, the ECB and the European Commission.

Activity

CONFIDENCE INDICATOR IN NON-FINANCIAL COMPANIES



Sources: HCOB, S&P Global, STATEC (last updated in July 2023)

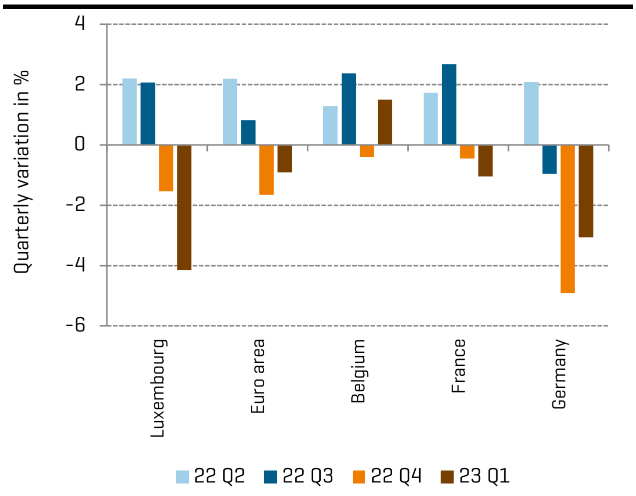
Weak outlook at the start of the third quarter

At the start of summer, morale among non-financial companies is falling. This trend can be seen both in Luxembourg and in the euro area, and can be explained by very similar factors: a further marked deterioration in confidence in manufacturing and construction since May and a downturn in non-financial services (where business confidence had been recovering in the first few months of 2023).

However, the extent of the downturn is relatively greater in Luxembourg, particularly for companies in the manufacturing and construction sectors. Manufacturing, metallurgy and metal products are the sectors that are hit hardest (as evidenced by sentiment about the state of the order books, stock levels and the production outlook). The decline in morale observed since mid-2022 in the construction sector was relatively more pronounced for building companies, but since May, civil engineering and specialised construction companies also report a significant fall in orders and employment prospects.

Real estate

SALES PRICES OF HOUSING



Source: Eurostat

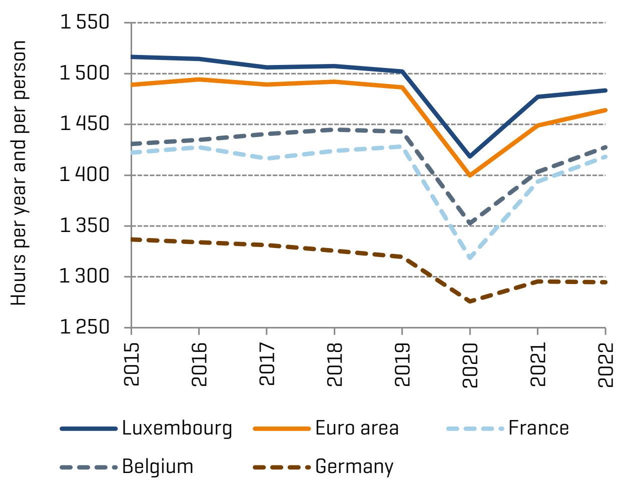
Decline in transactions and sale prices

In the first quarter of 2023, Luxembourg recorded the sharpest fall in house prices in the euro area (-4.1% over a quarter). Property prices are falling more in Luxembourg than in France and especially more than in Belgium, the only neighbouring country with an increase in early 2023. The trend in Luxembourg is more similar to that in Germany, with both countries displaying a fall in house prices of close to 6% two quarters after the last peak. However, sales prices began falling earlier in Germany, so that price levels in Q1 2023 were already around 9% below peak.

The downturn in sales prices affects all types of property in Luxembourg and particularly new apartments (-6.2% over one quarter in Q1 2023). The fall in demand, linked in particular to rising interest rates, has had a major impact on the number of property transactions. They fell by 50% year-on-year in early 2023, with, as in the case of prices, a sharper decline for apartments under construction (-72%), which reached a historic low (174 transactions in Q1 2023, compared with 632 a year earlier).

Labour market

AVERAGE WORKING HOURS*



Sources: STATEC, Eurostat (national accounts)
* Working hours include overtime and exclude paid leave.

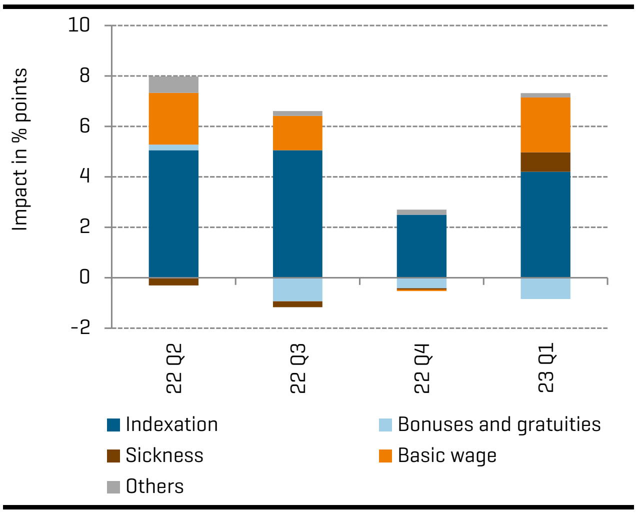
Hours worked remain on a downward trend

Last year, hours worked continued their post-Covid crisis rebound that began in 2021, but in Luxembourg – as in its neighbouring countries – they remain 1–2% below 2019 levels. For the current and next year, STATEC expects a further fall (-0.7%, then -0.3%, see Note de Conjoncture 1-2023), continuing the downward trend observed before the crisis erupted.

Thus, on average, an employee in Luxembourg worked 33 hours less (-2.2%) in 2022 than in 2015. This fall was lower than in Germany (-42 hours), but larger than the euro area average (-24 hours) and the quasi-stagnation in Belgium and France (-3 and -1 hours). The sectors driving these decreases are similar across countries: manufacturing (-71 hours in Luxembourg since 2015), trade, transport and hospitality (-55 hours), construction (-43) and the public sector (-29). In the Grand Duchy, average hours worked in the financial and business services sectors almost stagnated over this period. Average hours worked remain higher in Luxembourg than in neighbouring countries, due not only to the statutory working time but also to other factors such as less recourse to part-time work (compared with Belgium and Germany).

Wages

ANNUAL CHANGE IN COMPENSATION PER EMPLOYEE



Sources: IGSS, STATEC

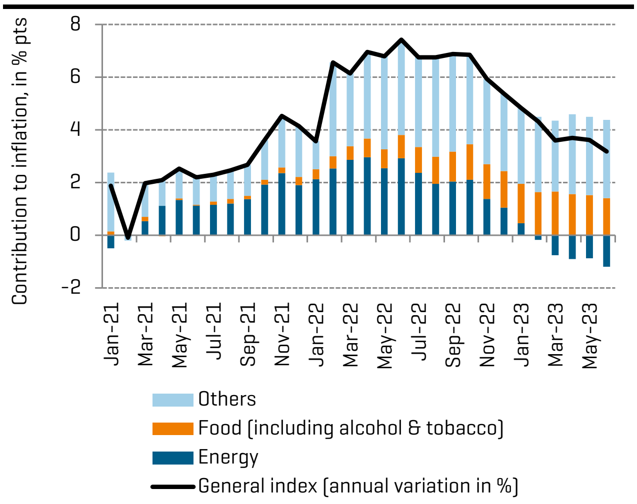
Compensation per employee accelerates in Luxembourg and the euro area

In Luxembourg, the compensation per employee rose by 6.5% year-on-year in Q1 2023, following relatively weak growth in late 2022. In the euro area and neighbouring countries, it accelerated to over 5% in Q1. Belgium stood out with a much higher increase (+9.5%), due in particular to a wage indexation at the start of the year.

Wage indexations also made the biggest contribution to growth in compensation per employee in Luxembourg at the start of the year, due to index brackets in April 2022 and February 2023. In addition, wage costs have been boosted by less sick leave than a year ago, while, as in previous quarters, the moderation of bonuses and gratuities had a downward impact. In contrast to Q4 2022, the base salary rose in early 2023, well beyond the impact of the minimum wage increase in January. The growth in compensation per employee by sector is similar to that of the economy as a whole, with the exception of accommodation and food services, where the rise was much more pronounced (+15.3%), and in financial and insurance activities and real estate activities (about +3.5% each, below the sliding wage scale).

Inflation

BREAKDOWN OF INFLATION IN LUXEMBOURG



Source: STATEC. Note: the volatility of inflation at the beginning of 2021 and 2022 is due to the postponement of the winter sales.

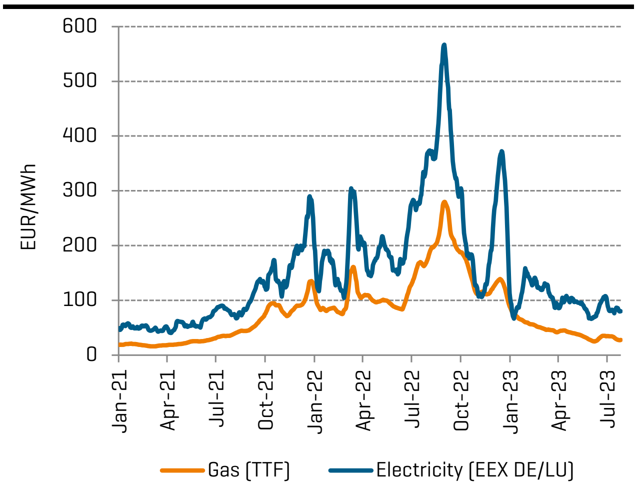
Slightly less pressure on food prices

In June 2023, the inflation rate continued to fall, reaching +3.2% year-on-year, compared with +7.4% a year ago. This easing is largely due to falling energy prices, which have contributed negatively to the national consumer price index since February (-1.2 percentage points in June).

However, food prices, which accelerated sharply after the invasion of Ukraine, are rising more slowly, at +11.2% year-on-year in June (after an all-time high of 13.3% in March). The reappearance of the El Niño phenomenon this year, which every 5 to 7 years disrupts the climate and agriculture across the planet, could however rekindle the surge in world food prices, as could the worsening geopolitical tensions affecting Ukrainian cereal exports. Excluding energy and food, inflation remains relatively stable but high (almost +4% over the first six months of the year). While goods prices are falling, services are set to become more expensive over the coming months, due to wage increases fuelled in particular by the three index brackets in 2023 (see Flash 6-23).

Energy

SPOT PRICES FOR GAS AND ELECTRICITY



Source: Macrobond (moving averages over 14 days)

Less volatility in electricity and gas prices on markets

Spot prices for electricity and gas have fallen considerably since peaking in 2022 but stabilised at above pre-crisis levels in Q2 2023. On the one hand, the fall in gas prices is attributable to efforts to reduce European consumption, supported by mild winter temperatures, which have reduced demand for gas in the EU (-13% year-on-year in Q1 2023). On the other hand, high storage levels after the winter have reduced uncertainty about the security of gas supply in the EU. Storages are currently more than 80% full (compared with 55% in 2021 and 65% in 2022 at the same period).

Electricity prices have followed a similar trend to gas prices. However, European electricity production has also been influenced by meteorological factors. Above-normal summer temperatures and persistent drought in 2022 reduced nuclear and hydroelectric production in the EU, a phenomenon that is very likely to recur this year.

Public finances

TAX RECEIPTS (CASH BASIS)

	2023 - 6 months	Evolution 2023/2022	
	In EUR M	*In EUR M*	*In %*
Household tax	4 408	312	7.6
VAT	2 530	70	2.8
Corporate tax	1 981	346	21.1
Excise duty	927	72	8.4
Subscription tax	595	-83	-12.3
Registration fee	142	-125	-46.8
Others	903	106	13.3
Total tax receipts	**11 486**	**696**	**6.4**

Sources: Tax authorities, STATEC

Tax revenues continue to rise

Tax receipts rose by 6.4% year-on-year in the first half of 2023. Taxes on households are still rising sharply and are the main driver of growth (accounting for almost half of the increase in revenues). Corporate tax was boosted in Q1 by a temporary recovery in receipts relating to previous tax years. Revenues from excise duties on tobacco and petrol rose again in Q2, unlike those from diesel sales (-5.5% year-on-year in the first half). The reduction in several VAT rates since January has weighed on the corresponding revenues, but these remain buoyed by the general rise in prices.

The recovery in stock market valuations led to an upturn in revenues from the subscription tax on company shares (after four consecutive quarters of decline), although these are still below the levels seen a year earlier. On the other hand, revenue from registration fees on property transactions has fallen sharply since the end of 2022 due to declining house prices and sales.

Trend chart

	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Average over the last three months	Same period previous year
										Annual variations in %, except where otherwise indicated	
Activity											
Industrial output per working day, in volume	-2.1	-1.7	-6.3	-7.8	-2.0	-0.3	-6.2	-5.4	...	-3.9	-1.6
Construction output per working day, in volume	-1.9	1.0	16.0	-11.8	0.7	-2.1	0.8	-2.6	...	-1.3	-2.3
Turnover by volume of total retail trade	-3.2	-2.0	-1.5	-1.3	-1.3	-2.0	-0.6	-1.7	...	-1.4	-2.5
Prices, wages											
Consumer price index (NCPI)	6.9	5.9	5.4	4.8	4.3	3.6	3.7	3.6	3.2	3.5	7.0
Underlying inflation	5.1	4.9	4.6	4.8	4.8	4.7	4.9	4.8	4.7	4.8	4.7
Oil product index	35.2	20.9	15.8	3.9	-3.5	-11.4	-13.5	-13.9	-17.4	-14.7	49.8
Industrial producer price index	23.0	20.3	19.0	17.7	13.0	9.7	2.2	-1.2	...	3.4	29.4
Construction price index[1]	15.9	15.9	15.9	14.1	14.1	14.1	12.3	12.3	12.3	12.3	13.9
Average wage bill, per person (National accounts)	2.2	2.2	2.2	6.5	6.5	6.5	...	...	...	6.5	6.8
Foreign trade											
Exports of goods (volume)	-1.8	-2.2	-11.4	1.4	-2.2	-0.3	0.6	-3.9	...	-1.2	-4.0
Imports of goods (volume)	-8.4	-0.6	-4.0	2.8	1.4	0.8	-9.2	-4.9	...	-4.3	-3.5
Employment, unemployment											
Domestic number of employees	3.3	3.2	3.4	2.8	3.0	2.7	2.7	2.4	2.2	2.5	3.5
National employment	2.6	2.6	2.7	2.2	2.3	2.2	2.2	2.1	1.8	2.0	2.4
Unemployment rate (% of working population, seas. adj.)	4.9	4.9	4.8	4.9	4.9	4.9	5.0	5.0	5.2	5.0	4.7

Source: STATEC

[1] Estimations based on half-yearly data

Indicators

	Quarterly variation in %					
	2022 Q1	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2
Eurozone - real GDP growth (European Commission)	0.6	0.8	0.4	-0.1	0.0	0.3
Luxembourg - real GDP growth (STATEC)	0.2	-0.1	1.5	-3.7	2.0	-
	Annual variation in %					
	2019	2020	2021	2022	Forecast 2023	Forecast 2024
Luxembourg - real GDP growth (STATEC)	2.3	-0.8	5.1	1.5	1.5	2.5

GDP at current prices 2022: EUR 78 130 million

Minimum monthly salary (since 01/04/2023): EUR 2 508.24

Current account balance (2023 Q1): EUR 242 million

Resident population (01/01/2023): 660 809

Consumer price index (06/2023) - base January 1st 1948: 991.47

Half-yearly average of the index linked to base as at January 1st 1948 (06/2023) : 980.22

Estimated deadline for next salary indexation: Q3 2023

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STATEC