CONJONCTURE FLASH

Economy and prices

MONTHLY PUBLICATION ON THE STATE OF LUXEMBOURG'S ECONOMY – **DECEMBER 2023**

A (NOT SO) UNUSUAL INVESTMENT CYCLE

Investment spending on housing (new builds) is one of the aggregates most affected by the rise in interest rates. Luxembourg seems to have been more affected by this rise than the euro area, which could be one of the factors behind the decline in activity in 2023.

Exceptional rise in key interest rates causes significant drop in lending...

Since July 2022, the increase in key ECB interest rates (+4.5 percentage points) has led banks to raise lending and deposit rates. As Luxembourg has a high proportion of variable-rate loans, rates on outstanding loans have adjusted faster and more sharply than elsewhere in the euro area. Rates on new mortgages rose from 1.5% in February 2022 (the low point) to 4.2% in September 2023 (4.7% for variable-rate loans). Non-financial businesses saw lending costs rise to 3.6% while average rates on outstanding consumer loans reached 3.1%.

Tightening monetary policy sent new lending volumes plummeting 60% year on year in September for businesses and almost 40% for real estate. Outstanding mortgages have fallen by an unprecedented amount since early 2023 (+8% in average growth over the last ten years) and outstanding loans to businesses in Luxembourg have fallen 6%.

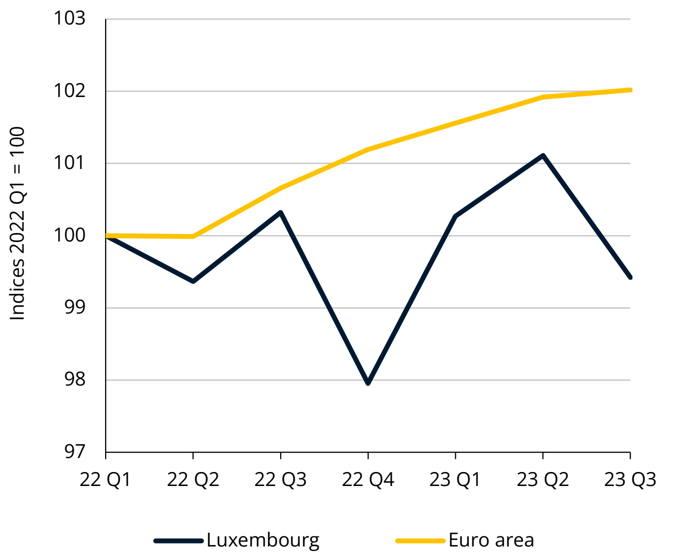
...and, in turn, demand

Although the rise in inflation since 2022 was essentially due to supply problems, the only way for central banks to bring it back to the medium-term target (close to 2% in the euro area) was to raise the borrowing costs, which curbed demand. The aggregates most sensitive to interest rates include residential investment, investment in machinery and equipment (by businesses)[1] and household consumption of durable goods. Together they account for 10 to 12% of GDP in Luxembourg.[2]

These aggregates were down following the rise in interest rates, with the exception of purchases of capital goods excluding aircraft and satellites. Housing was the most affected. Since peaking in 2021, this has fallen by around 20% (in real terms).[3] This high point broadly coincided with the start of the upward cycle in interest rates, whereas the downward trend in household purchases of durable goods began some time later. The corresponding maximum fall was almost 3%, with a slight upturn since early 2023.

There seems to have been something of a mirror effect in investment expenditure: after falling up to late 2021, investment spending on machinery and equipment has been rising since (although this dropped notably in the first estimate for Q3).

INVESTMENT IN HOUSING, MACHINERY AND EQUIPMENT AND CONSUMPTION OF DURABLE GOODS



Sources: STATEC, Eurostat (data in constant prices, seasonally adjusted and smoothed)

This atypical behaviour seems to be due to the delayed effects of the pandemic: bottlenecks in delivery (and production) chains caused major backlogs, which were subsequently partly recovered. The main assets affected were motor vehicles, where capital expenditure was up almost 20% year on year in the first three quarters of 2023. The effects of the rise in rates could therefore be felt with a certain time lag on future investment by non-financial companies in Luxembourg.

In the euro area, investment in housing, the only aggregate of the three to decline, fell almost 5.5% between Q2 2022 and Q3 2023. Consumption of durable goods has been stagnating since 2021, while investment in machinery and equipment has risen, like in Luxembourg. However, the resulting (overall) upward trend appears to be fading, rising just +0.1% in Q3. The fact that these interest-rate-sensitive aggregates in the euro area are performing better in comparative terms no doubt partly explains why Luxembourg was the only country to enter recession in 2023.

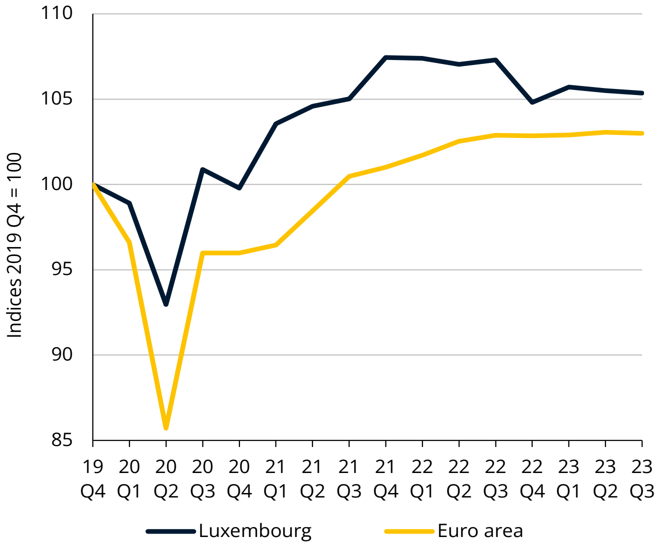
[1] Excluding aircraft and satellites.
[2] By their very nature, quarterly national accounts data are initially estimated and revised several times before converging to their final version. This process can take up to four years.

[3] This only relates to purchases of new builds (houses or flats), whereas the property market depression has mainly affected older properties, where prices have fallen far more.

STATEC

Activity

REAL GDP IN LUXEMBOURG COMPARED TO THE EURO AREA



Sources: Eurostat, STATEC (seasonally adjusted data)

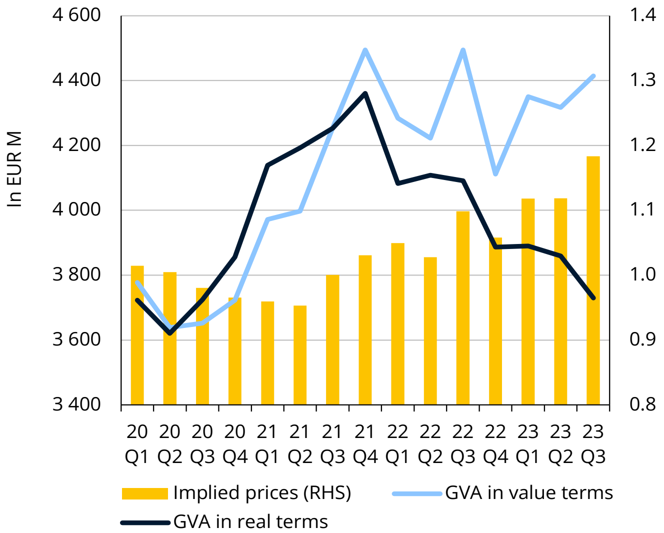
Slight technical recession

Real GDP in Luxembourg fell slightly in Q3 2023 (-0.1% over one quarter). Having already fallen 0.2% in Q2, the Luxembourg economy is now in a technical recession (which requires two consecutive quarters of negative growth in terms of quarter variation). Subsequent revisions could, however, contradict this finding, as falls recorded over these two quarters were slight. On the other hand, a recession over the year as a whole (relative to 2022) seems inevitable: with growth at -1.1% at the end of Q3, there would need to be an extraordinary rebound in Q4 to avoid this, which seems unlikely given the recent backdrop (up to November, business surveys were not showing significant signs of improvement).

The third quarter was again marked by a fall in value added in volume terms in the financial sector (see below) and by a decline in transport services. Construction activity continued to deteriorate, albeit less sharply than in Q2. On the other hand, value added recovered slightly in accommodation and food service activities, information and communication services and manufacturing.

Financial sector

GROSS VALUE ADDED (GVA) IN THE FINANCIAL SECTOR



Source: STATEC (seasonally adjusted data)

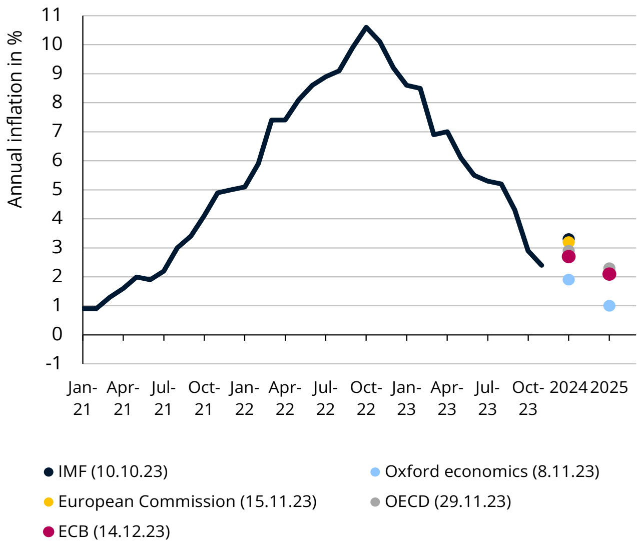
Reduction in volumes of assets in the financial sector

The downward trend in gross value added (GVA) in real terms in the financial sector continued in Q3 2023 (-3.4% quarter on quarter, it -8.8% year on year), which weighed on GDP, while GVA at current prices in the sector rose (+2.2% quarter on quarter, -1.8% year on year). The only thing supporting financial sector results are price effects (rising interest rates and stock market valuations) which are cancelled out in estimates of value added in real terms.

While banks have continued to benefit from the sharp rise in interest income, the fall in outstanding loans to the private sector (-3.3% year on year in Q3) has weighed on GVA in real terms. Custodian banks and fund management companies were hit by falls in net fees and in investment fund assets (-1% in net assets over one year). Net issuance fell for all asset types except money market instruments, which were more profitable as interest rates rose. GVA in life insurance has been affected by the fall in premiums collected since mid-2022 (down 17% year on year over the last four quarters). However, unlike in previous quarters, falling premiums concerned only unit-linked products, while premiums on guaranteed-return products (which are now earning higher yields due to rising interest rates) are now increasing again.

Inflation

INFLATION AND INFLATION FORECASTS IN THE EURO AREA



Sources: Eurostat (Nov-23: flash estimate), forecasts: as indicated

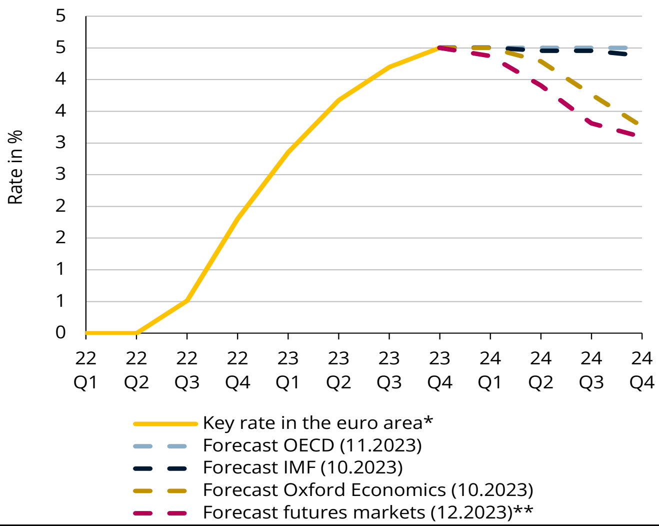
Inflation lower than expected

According to Eurostat's flash estimate, consumer prices in the euro area rose 2.4% year on year in November, down from +2.9% in October. This confirms the disinflationary trend observed in previous months (the consensus forecast was 2.7%) and this prompted a positive response from the financial markets. The October/November forecasts from international institutions (OECD, European Commission and IMF) are still predicting inflation of between 2.9% and 3.3% in 2024, although these figures could be revised downwards given the latest prices observed. The ECB has already downgraded its outlook for 2024 (from 3.2% in September to 2.7% in December).

The fall in inflation, which reached its highest level for over 40 years in October 2022, is therefore continuing apace. All the major inflation aggregates have fallen in the last few months. Since energy prices eased in late 2022, inflation in non-energy industrial goods has gradually weakened (since March), as has food inflation (from April) and finally services inflation (from September). These factors considerably weaken the prospect of a price-wage spiral and a self-sustaining inflation dynamic.

Financial environment

KEY INTEREST RATES IN THE EURO AREA



Sources: Macrobond forecasts: as indicated
*Key rate on the main refinancing operations in the euro area.
**Money market rates in the euro area (€ster)

Are rates set to fall soon?

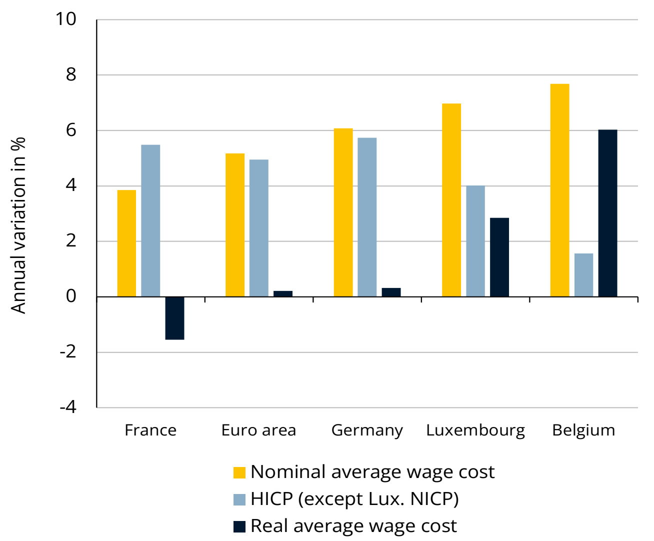
Central banks in the euro area, the UK and the US left their key interest rates unchanged at their latest monetary policy meetings. There seems to be a consensus that key rates have reached a fairly restrictive level and that there is no need to raise them further. However, the banks have not yet indicated when rates will start to be lowered.

The US Federal Reserve has internally discussed a rate cut schedule for 2024 and all but three policy-makers anticipate cuts of at least 50 basis points next year. While the Governing Council of the European Central Bank has not given any indication of future rate cuts, the sharp fall in inflation in the euro area gives reason to hope of an initial rates cut in the next few quarters.

The markets are anticipating an initial rate cut in the euro area at the start of Q2 2024, as is Oxford Economics, while the IMF and the OECD are forecasting that rates will only be cut from late 2024/early 2025.

Wages

COMPENSATION PER EMPLOYEE (CPE) IN Q3 2023



Sources: Eurostat, STATEC

Real wages rise again in the euro area

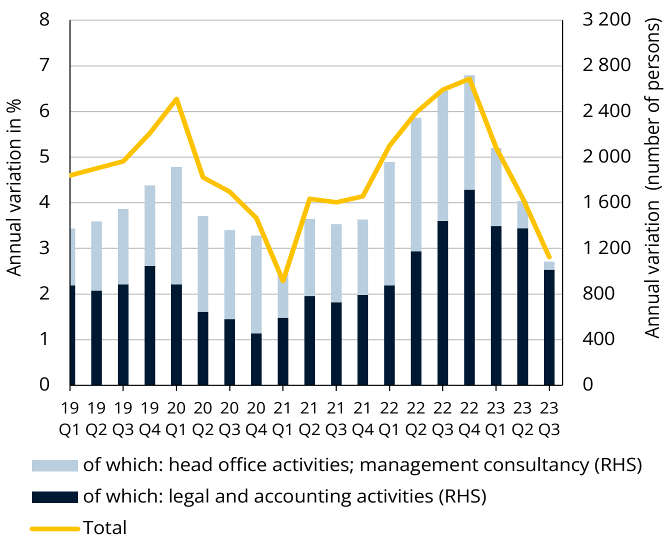
In Luxembourg, nominal compensation per employee rose 7% year on year in Q3 2023, slightly more than in previous quarters. Indexation is having an increasing impact (by about 6 percentage points in Q3), while other growth drivers are weakening. Compensation per employee in the euro area grew 5.2% year on year, slightly less than in the previous quarter, due in particular to a slowdown in CPE in France.

Real wages in the euro area rose for the first time in two years in Q3 2023 (+0.2% year on year). In fact, three quarters of European countries are once again posting growth in real CPE (compared with one quarter in Q1 2023). France is the only neighbour country where real CPE has continued to fall (-1.5%) after a relatively small rise in nominal CPE and inflation exceeding euro-area levels (a first since 2020). Real wages have risen more strongly in Luxembourg (+2.8%) and Belgium (+6%) and have been doing so since the start of the year.

Despite the positive trend in Q3, real wages in the euro area fell 1% in the first nine months of 2023 compared to the same period in 2022. In Luxembourg, by contrast, real CPE rose 2.7% over this period.

Labour market

PAYROLL EMPLOYMENT IN SPECIALISED, SCIENTIFIC AND TECHNICAL ACTIVITIES



Sources: STATEC, IGSS

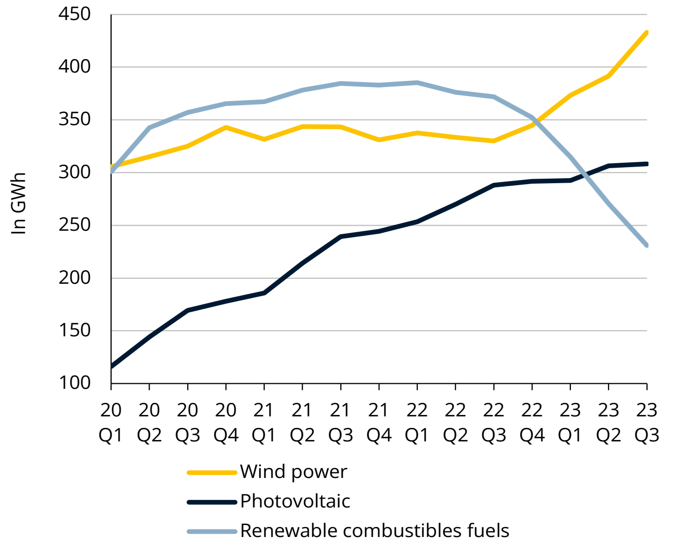
Marked slowdown in some service activities

Employment in Luxembourg has slowed sharply in recent quarters, rising just 0.2% over one quarter in Q3 2023 (seasonally adjusted data), similar to elsewhere in the euro area (even though it is usually higher in the Grand Duchy). As well as construction, the specialised, scientific and technical activities have played a major role in this slowdown. This sector, which is classified under business services, has been a major driver of employment growth in recent years (+17 000 jobs between 2015 and 2022, corresponding to almost one fifth of total growth), but this is no longer the case.

The downturn is due in particular to legal and accounting activities and company administration activities. These remained extremely dynamic last year (+6% and +11% respectively for paid employment) but employee numbers virtually stagnated from April to September 2023 (seasonally adjusted data). The deterioration is also seen in job prospects (derived from the monthly business surveys), which fell from early 2023 and were showing no clear signs of recovery up to November.

Energy

ANNUAL PRODUCTION* OF RENEWABLE ELECTRICITY



Source: Eurostat. *Production over the last four quarters

Wind power now the largest source of renewable electricity

Since 2019, renewable electricity production has been particularly marked by an expansion in photovoltaic production, which has almost tripled.

In 2023, however, wind power has been the most dynamic, becoming the main source of renewable electricity in Luxembourg, with almost 450 GWh produced in the last twelve months. Production has risen by more than 30% in the space of a year. This growth in wind power is due in part to the completion of several repowering projects. With the projects currently under way, wind power production should continue to increase in the coming years.

However, renewable fuels have gone the other way, falling almost 40% year on year. This fall was mainly due to a decline in production from waste wood, which accounts for around 50% of renewable fuel production.

Dashboard

	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-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	-1.4	-7.4	-7.1	-6.3	-6.6	-5.0	-10.3	...	...	-7.5	-0.3
Construction output per working day, in volume	-2.1	0.8	-2.6	-0.5	-1.1	7.1	-2.4	...	...	0.1	0.2
Turnover by volume of total retail trade	-5.1	-4.4	-3.0	3.4	-0.7	-2.3	-3.7	...	...	-2.2	1.6
Prices, wages											
Consumer price index (NCPI)	3.6	3.7	3.6	3.2	3.7	4.2	4.0	3.2	3.0	3.4	6.6
Underlying inflation	4.7	4.9	4.8	4.7	4.9	4.5	4.3	4.2	3.9	4.1	5.0
Oil product index	-11.4	-13.5	-13.9	-17.4	-12.8	-1.3	-0.6	-10.8	-9.2	-7.0	30.7
Industrial producer price index	9.7	2.5	-1.4	-3.8	1.8	1.4	1.9	-1.1	...	0.7	23.8
Construction price index[1]	14.1	12.3	12.3	12.3	...	...	...	...	...	12.3	13.9
Average wage bill, per person (National accounts)	6.4	6.8	6.8	6.8	7.0	7.0	7.0	...	...	7.0	6.0
Foreign trade											
Exports of goods (volume)	-0.6	-0.7	-4.8	-0.2	5.0	-3.0	-1.0	1.9	...	-0.6	-0.6
Imports of goods (volume)	2.5	-8.7	-2.9	-1.3	-4.5	1.3	-1.6	0.1	...	-0.1	0.4
Employment, unemployment											
Domestic number of employees	2.7	2.7	2.4	2.2	1.9	1.9	1.7	1.4	...	1.6	3.3
National employment	2.2	2.2	2.1	1.9	1.7	1.5	1.5	1.3	...	1.4	2.4
Unemployment rate (% of working population, seas. adj.)	4.9	5.0	5.0	5.2	5.2	5.3	5.5	5.6	...	5.5	4.8

Source: STATEC
seasonally adjusted, quarterly national accounts
1 Estimates based on half-yearly data

Indicators

	Quarterly variation in %					
	2022 Q2	2022 Q3	2022 Q4	2023 Q1	2023 Q2	2023 Q2
Eurozone - real GDP growth (European Commission)	0.8	0.3	0.0	0.0	0.2	-0.1
Luxembourg - real GDP growth (STATEC)	-0.3	0.2	-2.3	0.9	-0.2	-0.1
	Annual variation in %					
	2019	2020	2021	2022	Forecast 2023*	Forecast 2024*
Luxembourg - real GDP growth (STATEC)	2.9	-0.9	7.2	1.4	1.5	2.5

* Forecast from the Note de Conjoncture 1-23 (June 2023)

GDP at current prices (2022)	Minimum monthly wage (01/09/2023)	Consumer price index (11/2023)	Current account balance (Q3 2023)	Resident population (01/01/2023)
EUR **77 529** million	EUR **2 570.93**	**998.8**	EUR **2 687** million	**660 809**
	Next scheduled wage indexation: **Q3 2024**	Index half-yearly average: **997.1**		

STATEC