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Introduction

In accordance with Council Regulation CE 1466/97, the Grand Duchy of Luxembourg presented its first stability and growth programme to the Council and the European Commission at the beginning of 1999. The present document is the ninth update of this programme, covering the 2006-2010 time period.

The present update of the stability and growth programme has been prepared in parallel with the 2008 draft budget law. The draft budget was presented to Parliament on 10 October 2007 and will be the subject of a final vote towards mid-December 2007. The draft budget is available on the website of the *Inspection générale des Finances* under <http://www.igf.etat.lu/pb2008.pdf>. This update also takes into account the key data of the multi-annual investment spending plan for the 2007-2011 time period.

The 9th update of the Luxembourg stability and growth programme has been approved by the Cabinet and transmitted to Parliament. It is available on the website of the Ministry of Finance under <http://www.mf.public.lu/>.

Parliament has also been notified of the Council's opinion on the previous update of the stability and growth programme.

I. General guidelines and objectives of fiscal policy

The general government budget balance returned to surplus in 2006 and surpluses amounting to 0.8-1.3% of GDP are forecast to be maintained over the course of the 2007-2010 period. Since 2006, Luxembourg has achieved its medium-term budgetary objective of -0.8% of GDP in structural terms, as defined in the 7th stability and growth programme update. Furthermore, its public debt is among the lowest in the entire European Union (6.9% of GDP in 2007).

Following the economic slowdown of 2001-2003, the general government budgetary situation deteriorated, with budget deficits registered in 2004 and 2005. In April 2006, the Government and the social partners, meeting within the Tripartite Coordinating Committee, agreed on a set of measures aimed at enhancing the competitiveness of the Luxembourg economy and at restoring balanced public finances through the implementation of structural measures. The primary objective of these measures was to slow down the growth in public expenditure. It was thus decided to modulate the automatic wage indexation system, to adjourn and stagger the adjustment of allowances and pensions in 2007, to disindex family benefits and to optimise public expenditure, in particular in relation to current operating expenditures (including staff) and investment spending. Furthermore, a certain number of specific measures at revenue level were decided (e.g. increase of long-term care insurance contribution rate payable by the insured party).

The adoption of the budgetary consolidation measures in April 2006 coincided with a renewed dynamism of the Luxembourg economy, the scope of which had not been fully anticipated. The effect of the budgetary consolidation measures decided by the Tripartite Coordinating Committee was thus enhanced by favourable economic circumstances and enabled a return to a balanced budgetary position at general government level from the 2006 fiscal year onwards. It will be maintained in 2007.

For the 2008 fiscal year, the strategic objectives of fiscal policy as outlined in the draft budget are as follows:

- balanced public finances and maintenance of a sufficient budgetary safety margin to offset possible unexpected negative shocks;
- public expenditure growing slower than the rate of economic growth;
- macroeconomic assumptions and consequently public revenue projections marked by great prudence;

- reinforcement of social cohesion and maintenance of an economic and institutional framework in favour of long-term economic growth.

In the medium term (2009-2010), the Government aims to protect the reaction capacity of its fiscal policy by maintaining budget surpluses. The rigorous control over the growth in public expenditure is imperative in the context of a high level of volatility of public revenues characteristic of a small and very open economy.

Furthermore, the maintenance over the projection horizon of a structural surplus, a low level of public debt and significant budget reserves of the pension system are essential factors for ensuring the long-term sustainability of public finances in a context of demographic ageing.

II. Economic situation and developments

II.1. The international economic environment: main assumptions

The vigorous expansion of the world economy continued during the first half of 2007. Economic growth in the European Union and the eurozone was robust and notably superior to the economic growth witnessed in the United States and Japan. The bursting of the real estate bubble in the United States during the summer of 2007, however, shook the financial markets and led to an increase in risk premiums, a tightening of credit conditions and a greater volatility of stock markets.

In Autumn 2007, it is still too early to assess the repercussions of this episode of high volatility of the financial markets on the real economy in the United States and in Europe, with the “central” scenario being that of a relatively moderate negative impact in 2007 and a more pronounced slowdown in 2008.

The macroeconomic scenario thus rests on the assumption of an economic growth in the European Union of 2.7% in 2007 and of a slowdown in growth in 2008 to a rate close to the potential growth rate, i.e. approximately 2%.

Inflation is largely determined by the price developments of energy and raw materials. Since the beginning of 2007, oil prices have been characterised by great fluctuations, ranging from \$50 in January to almost \$80 in July. At the end of August, prices had dropped to around \$70, only to reach almost \$90 in October. The present stability programme is based on the technical assumption of oil prices exceeding \$75/barrel in the 2008-2010 period. In the medium term, the risks weighing on the general price level appear to be rising, in particular also due to the recent increase in food prices. Nevertheless, a slowdown in economic growth in the eurozone, should it materialise in 2008, would result in a relaxation of the capacity constraints, which are starting to make themselves felt in certain sectors of the European economy, thus reducing inflationary pressures.

Furthermore, current account imbalances in certain non-EU economies remain at a high level and the scenario of a disorderly unwinding of global imbalances represents a considerable downside risk for the growth outlook of the world economy.

It should be noted that economic growth in the eurozone has exhibited resilience to external shocks and that the impact of the energy price increase or the increase on 1 January of the VAT in Germany has not generated the anticipated negative effects on economic growth.

Consequently, the macroeconomic scenario outlined in this stability programme update is marked by cautious optimism. With the European economic cycle approaching maturity, economic growth will slow down but remain close to potential growth. Nevertheless, recent developments, in particular on the financial markets, imply that the balance of risks is tilted to the downside.

II.2. The Luxembourg economy in 2007

In 2006, economic growth in Luxembourg reached 6.1%, its highest level since 2000. The Luxembourg economy took advantage of a favourable international environment, in particular following the acceleration in economic growth witnessed in the eurozone. Despite the economic cycle seemingly having reached maturity and notwithstanding the volatility on the financial markets in the summer of 2007, there are no indications suggesting a break in growth and the economic growth is forecast to remain robust in 2007, amounting to 6%.

As a result of the impetus from investment acceleration, economic growth in 2007 was strongly supported by domestic demand. Net exports of goods and services also continued vigorously to feed economic growth, despite their contribution having diminished in comparison with 2006. Service exports continued to benefit from the dynamism in the financial sector while the growth of goods exports remained robust, following a good performance witnessed in exports of the steel industry, the chemical manufacturing industry and that of machinery and equipment. On the other hand, imports of goods and services will have developed more rapidly than exports in 2007, mainly as a result of the impetus from the regained dynamism of domestic demand.

Inflation, which in 2006 was still close to 3% (HICP and NICP), will have slowed down significantly in 2007, while nevertheless remaining above 2%. The drop in inflation is due largely to favourable base effects linked to the increase in energy prices in 2006. In parallel, the prices of other goods and services increased and the underlying inflation exceeded 2% in 2007. Despite the slowdown in inflation, the inflation differential in comparison with the eurozone remained unfavourable in Luxembourg.

Developments on the employment market continue, on the face of things, to be contradictory. On the one hand, domestic employment is in full swing, increasing by 3.7% in 2006 and by 4.1% in 2007. The proportion of cross-border workers in total employment continues to increase and is henceforth close to 40%. On the other hand, despite robust economic growth, the unemployment rate remains at a level deemed high for Luxembourg – even increasing slightly from 4.8% in 2006 to 4.9% in 2007 – suggesting that the problem of unemployment in Luxembourg is essentially a structural, rather than a cyclical, phenomenon.

It should be noted that the dynamic employment market does not reflect the performance of a limited number of sectors, such as the financial sector, but is a phenomenon widespread over all the sectors of activity, with the exception, however, of the general government sector.

Average wage cost developments continue to be very dynamic, in line with economic growth developments. Nevertheless, in comparison with 2006, average wage cost growth will have slowed down from 4.5% to 4.1% in 2007. Following the slowdown of inflation in 2007 and pursuant to the decision adopted by the Tripartite Coordinating Committee regarding the adjustment of the automatic indexation system, wages were not adjusted to living cost developments over the course of 2007. Indeed, the last wage adjustment in accordance with the automatic indexation mechanism took place in December 2006 and the next adjustment is scheduled to occur in March 2008.

II.3. Medium-term macroeconomic forecast, 2008-2010

The macroeconomic forecast underlying the preparation of the 2008 draft budget and the present stability programme update was elaborated by Statec in September 2007. It takes into account certain qualitative elements linked to the volatility on the financial markets that took place during the summer of 2007, but it was still too early to proceed with an exact quantification of these effects. Furthermore, it should be emphasised that the Statec forecast regarding the main macroeconomic aggregates does not yet include all the measures adopted in October by the Government in the context of the preparation of the 2008 draft budget.

The volatility observed on the financial markets in the summer of 2007 and the ensuing repricing of risk imply that the medium-term macroeconomic forecast is characterised by an increased uncertainty.

Owing to the weight of the financial sector in the Luxembourg economy, the consequences of a potential prolonged period of volatility and uncertainty on the “real” economy would be enhanced in comparison with the other European economies. This was already the case in 2000, following the bursting of the speculative bubble on the stock markets. Indeed, at this time, the slowdown of economic growth was noticeably more pronounced in Luxembourg than elsewhere.

Consequently, the central scenario foresees a slowdown in economic growth of 6% in 2007 to 4.5% in 2008. Following the external shock gradually wearing off, economic growth should accelerate slightly to reach 5% in 2009. In 2010, the economy is forecast to develop in line with potential growth, i.e. with real growth amounting to 4%.

The external shock will affect the Luxembourg economy via a slowdown in economic growth in the eurozone and subsequently via a slowdown in activity in the financial sector. Consequently,

net exports of goods and services will slow down significantly. The increase in uncertainty will furthermore bring about a slowdown in investment. The other components of domestic demand – private consumption and public consumption – will resist the downward trend.

As a result of the impetus from growth levelling off, the inflation rate (HCPI) will slow down and be close to 2% per year during the 2008-2010 period. In 2008, increases of agricultural prices will continue to exert upward pressure on inflation while downside risks persist in relation to the price developments of energy and non-agricultural commodities.

Employment developments follow the dynamics of economic activity with a certain time-lag. Thus, employment growth will slow down after 2008, but growth rates will remain high: in 2008, domestic employment will increase by 3.9% but the economic slowdown will eventually implicate a gradual deceleration in employment growth to 3.6% in 2008. Historically speaking, the unemployment rate will remain high (> 4.5%), even if it starts to slightly decrease from 2008 onwards. The slowdown in economic growth will also imply a slowdown in the development of the average wage cost during the 2008-2010 period.

Structural reforms: introduction of a unified status for private sector workers

On 27 July 2007, the Government adopted the draft bill introducing a unified status for private sector workers.

In the context of the Tripartite Coordinating Committee meetings held between October 2005 and April 2006, the Government and the social partners agreed to merge the statuses of private labourers and that of private employees with a view to setting up a single unified status encompassing all private sector workers.

In its opinion issued on 28 April 2006, the Tripartite Coordinating Committee outlined the details of the conclusions of this agreement.

The introduction of a unified status represents a major structural reform, putting an end to the differences, the discriminations even, between private sector labourers and private sector employees. The unified status will thus give rise to a Labour Code applicable uniformly to all workers employed under private law.

The single status for workers of the private sector foresees in particular:

- the generalisation of continued sickness leave payments;
- the adaptation of the labour law;
- the administrative reorganisation of the social security system.

For businesses, the introduction of the single unified status will bring about a reduction in administrative costs in the sense that the separate management of two different personnel categories will become redundant. The unified status will confer a competitive advantage to businesses by lowering the overall level of social contribution rates.

The unified status will also allow the sickness funds and pension funds of the private sector to be merged and it will lead to the creation of one single professional chamber for workers of the private sector. The unified status thus fits into the context of a structural modernisation and greater efficiency while benefiting from cost savings.

The unified status is scheduled to enter into force on 1 January 2009.

III. Budgetary situation and public debt

III.1. General guidelines of fiscal policy and medium-term objectives

Since 2006, the general government budgetary situation has once again yielded a surplus and Luxembourg has achieved its medium-term budgetary objective of -0.8% of GDP in structural terms, as defined in the 7th stability programme update. This medium-term objective reflects the high potential growth ($\pm 4\%$) and the low level of public debt (debt ratio of $\pm 7\%$ of GDP) of Luxembourg, while maintaining an appropriate budgetary safety margin below the 3% of GDP reference value for the public deficit.

Following the economic slowdown of 2001-2003, the general government budgetary situation deteriorated and budget deficits were registered in 2004 and 2005. In April 2006, the Government and the social partners, meeting within the Tripartite Coordinating Committee, agreed on a set of measures aimed at enhancing the competitiveness of the Luxembourg economy and at regaining a balanced budgetary position. The primary objective of these measures was to slow down the growth in public expenditure. It was thus decided to modulate the automatic wage indexation system, to adjourn and stagger the adjustment of allowances and pensions in 2007, to disindex family benefits and to optimise public expenditure, in particular in relation to current operating expenditures (including staff) and investment spending. Furthermore, a certain number of specific measures at revenue level were decided (e.g. increase of the long-term care insurance contribution rate payable by the insured party, increase of VAT rate applicable to certain service provisions).

The adoption of the budgetary consolidation measures in April 2006 coincided with a regained dynamism of the Luxembourg economy, the scope of which had not been fully anticipated. Indeed, economic growth accelerated to reach 6.1% in 2006. In addition, the general government budgetary situation was positively affected by an exceptional event (Arcelor-Mittal merger), of which the total impact on the budgetary balance amounted to approximately 0.4-0.5% of GDP (of which 0.3% of GDP can be qualified as temporary/one-off). Consequently, the effect of the measures adopted by the Tripartite Coordinating Committee was thus enhanced by the favourable economic circumstances and allowed the return to a balanced budgetary position at general government level from the 2006 fiscal year onwards.

The implementation of these budgetary consolidation measures and the application of great discipline in matters of public expenditure control have enabled a balanced position of public finances to be regained and sufficient budgetary leeway to be created for financing the Government's important financial commitments and policies, which are to be implemented in favour of long-term economic growth, without however increasing the tax burden or placing an excessive burden on future generations. In terms of these political commitments, policies that merit

particular attention include those involving social equity, employment – in particular those aiming to reduce unemployment – education and research, the development of a more efficient public transport service and the protection of the environment.

As shown in the table below, the general government budgetary situation yielded surpluses in 2006 and 2007 and a net lending capacity amounting to 0.8-1.2% of GDP per year is forecast over the course of the 2008-2010 period:

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---------------------------|--------------|--------------|--------------|--------------|--------------|
| General government | +0.7% | +1.0% | +0.8% | +1.0% | +1.2% |
| Central government | -0.9% | -0.9% | -1.4% | -1.4% | -1.4% |
| Local government | -0.2% | -0.1% | -0.1% | -0.1% | 0.0% |
| Social security | +1.8% | +2.0% | +2.4% | +2.5% | +2.6% |

Note: in % of GDP

The budgetary objectives have thus been achieved more rapidly than anticipated in the previous stability programme update. The fact that the regaining of the balanced budgetary position was achieved essentially through the consolidation of public expenditure shows that there is a satisfactory degree of “institutional” capacity to offset negative shocks and to absorb the repercussions thereof. On the other hand, however, the strong sensitivity of the public finances with regard to cyclical developments highlights the essential need to foresee sufficient budgetary safety margins in the event of an unexpected negative shock and thus to maintain a sufficiently high budgetary surplus during favourable economic periods.

It should be noted that the budgetary objectives defined by the Government are expressed in nominal terms and not in structural terms. Indeed, in the case of Luxembourg, the computation – in particular ex ante – of the cyclically-adjusted balance (and thus of the structural balance) is affected by a relatively wide margin of imprecision. The “community” method for estimating the output gap is based on the computation of the “natural” unemployment rate (Nairu). Due to the strong presence of non-resident workers on the Luxembourg labour market, however, the Nairu concept poses a problem owing to the fact that labour supply is highly elastic. Alternative methods for estimating the output gap (e.g. by Statec) yield results that differ considerably from output gap estimations based on the “community” method. Hence the definition of the budgetary objectives in nominal terms.

III.2. Budgetary situation in 2006 and 2007

On 1 October 2007, Luxembourg notified the European Commission of a general government net lending capacity of 0.7% of GDP in 2006 and of 1.0% of GDP in 2007. These budget balances are markedly better than the projections presented in the previous stability programme update.

The balanced budgetary position was regained in 2006 thanks to the application of a strict control at the level of budgetary expenditure and to a favourable economic environment (6.1% economic growth in 2006). Furthermore, the general government budget balance has been favourably affected by a unique transaction, of which the temporary/one-off component is estimated to equal 0.3% of GDP. In 2006, in the context of the Arcelor-Mittal merger, Arcelor S.A. paid out dividends that were markedly higher than anticipated. The outbound dividends were subjected to capital income tax withheld at the source. The tax revenue generated on the unexpected part of the distributed profit is treated as a temporary/one-off component in the present stability programme update. In this context, it should furthermore be pointed out that the State – as a shareholder of Arcelor S.A. – also achieved income amounting to €408 million (1.2% of GDP) resulting from the exchange operation of Arcelor shares against cash and Mittal shares. However, taking into account that this was a financial transaction, this operation did not have an impact on the general government budget balance, in accordance with the regulations and concepts of the ESA95.

In 2007, the economic environment remained favourable, with a real growth in GDP amounting to 6%. Furthermore, in the context of the 2007 budget implementation, the majority of the consolidation measures adopted during discussions within the Tripartite Coordinating Committee were implemented (other measures having been implemented by means of specific laws).

Thus, the ratio between public expenditure and GDP went from 39% in 2006 to 37.5% in 2007. This drop can be explained essentially by a 1% of GDP reduction in the share of social transfers, as well as by a reduction in the share of “current” public expenditure. Both developments are to be seen in direct relation with the measures adopted in the context of the Tripartite Coordinating Committee: adjustment of the automatic wage indexation system, restriction of the number of additional public servants being employed at central government level, introduction of a “ceiling” for “current” central government expenditure, disindexation of family benefits, adjournment and staggering of the adjustment of allowances and pensions scheduled for 1 January 2007. Improved management and tighter control have enabled expenditure linked to sickness benefits to be stabilised. It should also be pointed out that the development of social transfers in cash – and in particular the development of pensions – is favourably affected by a moderate growth in the number of pension beneficiaries. This demographic effect will continue to have a favourable effect on the development of social transfers in the short and medium term. This is nevertheless a

phenomenon of which the effects are limited in time: in the longer term, the effect of demographic ageing on public finances will be clearly negative.

The ratio between public revenue and GDP also diminished, going from 39.7% in 2006 to 38.5% in 2007. This reduction can be explained essentially by the development of taxes, the GDP share of which went from 25.3% in 2006 to 24.4% in 2007. The GDP share of current taxes on income and wealth (“direct taxes”) decreased by 0.3% in comparison with 2006. This reduction, however, corresponds exactly to the temporary/one-off measure described above. Consequently, without taking into account this temporary/one-off measure, which occurred in 2006, direct taxes have developed in line with nominal GDP growth. The GDP share of taxes on production and imports (“indirect taxes”) decreased by 0.6% in comparison with 2006. The development in 2007 of the indirect taxes is characterised by two contradictory trends: on the one hand, the development of the revenue, which is in direct relation to the economic cycle – such as value added tax or the subscription tax – is dynamic; on the other hand, the level of excise duty revenue stagnates in 2007. This stagnation in revenue is fully anticipated and mirrors the measures adopted by the Government in the context of its policies aimed at achieving better qualitative results in terms of health provision and environmental protection (“Kyoto”).

III.3. Budget for 2008 fiscal year

On 10 October 2007, the Government submitted to Parliament the draft budget for the 2008 fiscal year. The 2008 draft budget presents a general government surplus of €337.8 million, i.e. 0.8% of GDP.

In terms of the sub-sectors of general government, the central government budget balance continues to show a deficit of 1.4% of GDP. The local government budgetary situation also shows a deficit, albeit close to balance (-0.1% of GDP). The social security budget balance continues to yield a comfortable surplus, amounting to 2.4% of GDP.

In comparison with the estimate of the budget balance for the 2007 fiscal year, the budget balance presented in the draft budget for the 2008 fiscal year is down by 0.2% of GDP but remains largely positive.

This reduction in the budget surplus can be explained mainly by the development of the revenue aspect of the draft budget, with public expenditure continuing to follow on the downward trend of the recent fiscal years.

Indeed, according to the draft budget, the ratio between public revenues and GDP will undergo a reduction from 38.5% in 2007 to 37.8% in 2008. This development can be explained by the

development of the taxes, the GDP share of which decreases from 24.4% to 23.6%. In terms of direct taxes, an adjustment to inflation of 6% of the personal income tax brackets will be carried out in 2008. Indeed, the personal income tax scale has not been adjusted to inflation since the 2001/2002 tariff reform. Despite the maintenance of average tax rates that are not very high in international comparison, the non adaptation of the rate has led to an implicit increase in the tax burden and given rise to high marginal tax rates in certain segments of the distribution of taxable incomes, in particular those of lower taxable incomes. In order to remedy this situation and to avoid possible disincentive and distortionary effects resulting from high marginal tax rates in certain income distribution segments, the Government is thus carrying out an adaptation to inflation of the personal income tax brackets.

Furthermore, the fiscal treatment of households with dependent children has been revised with the introduction of a tax bonus for children. From 1 January 2008, the tax reduction for children, which households with dependent children currently benefit from, will be replaced by the said tax bonus for children, which will be allocated to all households with dependent children. It will therefore be particularly advantageous to households with low taxable incomes, to the extent that their disposable income will increase as a result of the introduction of the tax bonus. The budgetary impact of these two measures will amount to approximately 0.8-0.9% of GDP in 2008.

The share in GDP of indirect taxes will decrease from 11.7% in 2007 to 11.2% in 2008. Several factors are responsible for this development. Firstly, the excise duty revenue will continue to stagnate in 2008 and beyond. Then, the turbulences witnessed in the summer of 2007 in the financial markets and their possible longer-term ramifications are likely to have a negative impact on the development of subscription tax revenues. Thus, the revenues foreseen in the draft budget for the 2008 fiscal year are lower than the revenues foreseen for the 2007 fiscal year. Finally, the draft budget for the 2008 fiscal year foresees a reduction in capital duty before its progressive phasing out, pursuant to a draft directive of the Council of the European Union concerning indirect taxes on the raising of capital, which foresees the abolition of capital duty by 2010.

According to the draft budget, the ratio between public expenditure and GDP will decrease from 37.5% in 2007 to 36.9% in 2008. As far as the development of public expenditure is concerned, the draft budget for the 2008 fiscal year is in line with the fiscal policy implemented since 2006: rigorous control of “current” expenditure, implementation of a public investment policy directed at the achievement of strategic priority objectives of the Government (development of road network, railway infrastructure investments, construction of schools). Furthermore, social transfers in cash continue to be oriented downwards in accordance with the consolidation measures adopted in the context of the Tripartite Coordinating Committee as well as the demographic effects identified above.

Additional budgetary means are freed up to enable the achievement of the strategic objectives of governmental action, in particular in the fields of social cohesion, research and development, environmental policy, housing policy, internal security and development cooperation.

In this context, it can be pointed out that budget provisions in favour of research and development are forecast gradually to increase from 0.25% of GDP in 2006 to 0.4% of GDP in 2009 and that the Government will continue to contribute financially to the development of the University of Luxembourg. In matters of environmental policy, the draft budget for the 2008 fiscal year foresees additional budget provisions with a view to achieving reductions in greenhouse gas emissions, in particular via the flexibility mechanisms defined in the Kyoto Protocol. It should be furthermore noted that in 2008, public development aid will amount to 0.91% of GNI.

III.4. Medium-term forecast, 2009-2010

The turbulences that have hit the financial markets in the summer of 2007 led to an increase in downside risks and growing uncertainties. In this context, the medium-term development of the general government budgetary situation is also marked by uncertainty.

In the central scenario, the general government will continue to free up net lending capacities amounting to 1% of GDP in 2009 and 2010.

The general government budget balance will improve in 2009 and 2010 to the extent that the financial situation of social security will undergo a favourable development. In the central scenario, the social security net lending capacity is foreseen to go from 2.4% of GDP in 2008 to 2.6% of GDP in 2010, mirroring on the one hand a sustained growth in the revenue of social contributions as well as improved returns on the budget reserves of the general pension system, and on the other hand a moderate variation of social transfers. Furthermore, the adjustment of the automatic wage indexation and the adjournment and staggering of the allowances and pensions continue to contribute to the control of the development of social transfers in cash, in particular by means of a favourable base effect.

For the general government as a whole, the ratio between public expenditure and GDP will continue to be around 37%, i.e. a level of public expenditure clearly lower than the European average. Except for the social transfers in cash, the development of which has been commented upon in more detail above, the other categories of public expenditure will tend to stabilise in 2009 and 2010. Public investment, however, will escape this rule. Indeed, the share in GDP of gross fixed capital formation is forecast to go from 3.9% of GDP in 2008 to 4.3% of GDP in 2010. This investment spending development mirrors in particular the investments in the development of the

road and railway networks and the development of the “Belval-Ouest” site, on which the University of Luxembourg and the “Gabriel Lippmann” public research centre will be established.

It should be noted that the share in GDP of the “other expenditure” will decrease from 4.3% in 2008 to 4.0% in 2010. This decrease can be explained in particular by a reduction in transfers to Belgium in the context of the sharing of joint excise duty revenue of the Belgium-Luxembourg Economic Union (BLEU). Indeed, the stagnation of excise duty revenue and the stabilisation or even reduction of fuel sales in Luxembourg as a result of the increase in fuel prices imply a gradual reduction of budgetary transfers to Belgium, which amounted to 0.55% of GDP in 2005 and 0.2% of GDP in 2006.

The ratio between public revenue and GDP will stabilise around 38% in 2009 and 2010. According to the central scenario, the economy will develop close to its growth potential in 2009 (a little higher) and in 2010 (a little lower). Consequently, the development of tax revenues is estimated on the assumption of an elasticity of revenue in relation to GDP that is close to unity. The assumption of an elasticity close to unity for the indirect taxes may appear prudent in light of the observed developments. Nevertheless, it should be pointed out that in the context of a stagnation or even a slight decrease in excise duty revenue, this prudent approach is fully justified.

As a result of the smallness of territory and the high degree of openness of the economy, public revenue developments are characterised by a relatively high degree of volatility. Furthermore, one-off phenomena tend to have a more significant impact on the general government budget balance than they would in larger Member States. Consequently, if warranted, the Government stands ready to implement additional budgetary consolidation measures if deemed necessary with a view to ensuring the respect of the commitments within the Stability and Growth Pact.

III.5. Public debt

Luxembourg general government debt remains well below the 60% of GDP reference value foreseen in Article 104 of the EC Treaty.

Indeed, in 2007, the ratio of general government gross debt to GDP is situated at 6.9%.

At the same time, the central government has reserves at its own disposal (special funds, budgetary reserve and financial fixed assets) amounting to €3.544 million, i.e. 9.5% of GDP. These reserves were accumulated in particular during the last decade, during which the central government budgetary situation was characterised by a series of budget surpluses.

Furthermore, the social security sector regularly generates surpluses and these surpluses are put in reserve in order to pay for future social transfers. At the end of 2006, social security had accumulated a reserve amounting to more than €8 billion, or 21.3% of GDP. Considering the central government's own reserves and the social security pensions reserve, the general government net debt is negative.

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|--------------------------------------|-------------|-------------|-------------|-------------|-------------|
| General government gross debt | 6.6% | 6.9% | 7.1% | 7.2% | 7.0% |
| Central government | 4.3% | 4.5% | 4.8% | 5.0% | 4.9% |
| Local government | 2.3% | 2.4% | 2.3% | 2.2% | 2.1% |
| Social security | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |

Note: in % of GDP

In addition to the government debt detailed hereafter, the central government debt also includes debt of public institutions.

The quantity of monetary signs issued by the Treasury as coins has increased rapidly since the replacement of Belgian and Luxembourg franc coins with euro coins. On 30 September 2007, euro coins worth €157.0 million were in circulation. To this can be added monetary signs in francs, which have yet to be reimbursed and which amount to €8.4 million.

The Treasury bills issued by the Government are not actually reimbursable funds collected by the Government. Instead, these bills enact long-term commitments *vis-à-vis* international financial institutions (AsDB, AsDF, EBRD, IFAD, GEF, IDA, MIGA, "Kyoto" carbon funds). These bills do not carry interest and they are paid if, and when, they are due. On 30 September 2007, outstanding bills totalled €56.8 million. The payment of the Treasury bills is carried out via the public debt fund or the "Kyoto" fund. According to currently known deadlines, the reimbursements of Treasury bills will amount to €14.9 million in 2007, €8.2 million in 2008, €8.5 million in 2009, and €7.8 million in 2010.

The Government did not issue new bonds during the fiscal years 1998 to 2005. On the contrary, it has in the meantime repaid the entire existing debt dating back to before 1998. The repayment of the last OLUX loan, to the capital amount of €94.48 million, was thus carried out in 2007.

For each of the years 2005, 2006 and 2007, the Government has been authorised to issue new debt with a view to financing infrastructure projects via the railway fund and the road construction fund, amounting to €100 million per year per fund, i.e. a total of €600 million. These authorisations have to date been only partially used by the taking up in 2006 of bank loans contracted for ten years to a total amount of €400 million. To this was added in 2007 a further

bank loan amounting to €132 million over ten years for the purpose of the government acquisition of the rail infrastructure owned by Arcelor S.A., which was the subject of a specific law dated 18 December 2006.

On 30 September 2007, gross public debt (excluding public institutions and the *Fonds pour la Loi de Garantie*) in the form of government bank loans amounted to €532 million (1.4% of GDP). It is denominated entirely in euro.

The 2006 draft budget also foresaw an authorisation enabling the Government to borrow an amount of €300 million to cover the budget deficit. This authorisation did not need to be used and a similar authorisation has no longer been foreseen in the 2007 and 2008 budget laws.

For the purpose of the stability and growth programme and in accordance with the multi-annual capital spending programme, this update assumes that the authorisations that still remain open for loans for the railway fund and the road construction fund (2 times €100 million) will be used in 2007. This update also assumes that loans in favour of the two above-mentioned funds (€100 million per year per fund) will be taken up during each of the years 2008, 2009 and 2010.

Furthermore, the Government has granted financial guarantees to property developers in view of the construction of certain public infrastructures (*Loi de Garantie*). In accordance with the Eurostat decision regarding the statistical treatment of public-private partnerships (Press release of 11 February 2004), these transactions are recorded as imputed loans in the general government accounts. Over the course of the 2007-2010 time period, the impact of this decision on the ratio between gross debt and GDP will vary between 2.0-2.2% per year.

Consequently, central government debt will increase from 6.9% of GDP in 2007 to 7.1% of GDP in 2008. It will reach 7.2% of GDP in 2009, before going back to 7.0% of GDP in 2010.

The reserves of the special fund dedicated to the repayment of the public debt will total close to €50 million at the end of 2007, so that, taking into account the budget provisions foreseen in the 2008 budget, the servicing of the debt, in terms of capital and interest, is already ensured for 2008. In the subsequent fiscal years, this debt service can be restricted to the repayment of the Treasury bills that are due and to the interest payable on contracted bank loans. The interest burden, which amounts to €59 million in 2007, will reach €57 million in 2008, €80 million in 2009, and €103 million in 2010 (central government only).

The Luxembourg local government debt remains at a low level in relation to GDP (2.4% of GDP in 2007). The aggregate debt of the local authorities and syndicates thus totals approximately €890 million at the end of 2007.

Local authorities may contract new loans only to finance extraordinary expenditures, only if no other source of finance is either available or economically efficient and only if annuities are

regularly repaid. The legislation stringently regulates the conditions under which local authority syndicates may contract new loans.

The social security debt is non-existent, given that this sector regularly generates surpluses.

IV. Sensitivity analysis and comparison with previous update

IV.1. Sensitivity analysis

In the central scenario, the turbulences in the financial markets from the end of July 2007 have led to a slight downwards revision of growth prospects in 2007. The downwards revision is a little more significant for the year 2008. Despite the growth in 2008 remaining close to potential growth, this cooling down mirrors on the one hand the fact that the economic cycle is reaching maturity and on the other hand the greater exposure of Luxembourg to the downside risks owing to the important role played by the financial sector in economic activity.

In the absence of exact quantitative information regarding the impact of the financial turbulences on the real economy, the central scenario is thus implicitly based on the assumption that the volatility witnessed in the summer of 2007 will not trigger a crisis of the financial system and that the negative effects on the real economy will gradually disappear.

In the alternative scenario developed below, the volatility of the financial markets would persist for a prolonged period with some downside risks materialising. The negative shock would spread through the financial system and trigger a drop in the European stock index amounting to 10% in relation to the baseline scenario. The global demand for goods and services would decrease by 1% in relation to the central scenario and the economic growth rate of the eurozone for 2008 would slow down by 0.5% in relation to the central scenario.

| | 2008 | | 2009 | | 2010 | |
|---|------|--------|------|--------|------|--------|
| Real GDP (variation in %) | 3.0% | (4.5%) | 4.9% | (5.0%) | 4.0% | (4.0%) |
| Domestic employment (variation in %) | 3.6% | (3.9%) | 3.2% | (3.7%) | 3.4% | (3.6%) |
| Unemployment rate | 4.8% | (4.7%) | 4.9% | (4.6%) | 4.9% | (4.6%) |
| Inflation (NICP) | 2.3% | (2.3%) | 2.1% | (2.2%) | 2.1% | (2.2%) |
| General government budget balance (% of GDP) | 0.6% | (0.8%) | 0.7% | (1.0%) | 0.9% | (1.2%) |

Note: values in brackets correspond to the central scenario

The external shock would be generated for the year 2008 only. From 2009 onwards, the principal external variables would regain an expansion path identical to that of the baseline scenario. Nevertheless, the impacts on the Luxembourg economy would also be felt in 2009 and 2010.

Following the occurrence of this negative shock, economic growth in 2008 would go from 4.5% in the central scenario to 3% in the alternative scenario. In 2009, the downwards revision of the real

growth would amount to only 0.1%, i.e. growth would accelerate to a rate close to or exceeding potential growth. In 2010, the negative effects on economic growth will have faded.

The slowdown in economic growth will have a significant impact on the labour market, in that the total employment growth will slow down while the unemployment rate will rise. In 2008, the employment growth would drop from 3.9% in the central scenario to 3.6% in the alternative scenario. Furthermore, the unemployment rate would be higher (4.8%) than in the central scenario. While at the level of economic activity, the effects of the negative shock would be concentrated essentially around the year 2008, the longer-term effects would be more significant on the labour market. Thus, in 2009 and 2010, the employment growth would be markedly lower than in the central scenario and the unemployment rate higher. This path mirrors the fact that the labour market reacts with a certain time-lag to the development of economic activity.

It should be pointed out that the impact of the negative shock on inflation and wages is more subdued.

The persistence of the negative shock on the labour market implies that, at the level of public finances, the repercussions of the shock will be making themselves felt in 2008 and beyond. In 2008, the negative effect on the general government budget balance essentially mirrors the slowdown in economic activity. In 2009 and 2010, the negative effect of the shock on the budget balance mirrors the longer-term effects on the labour market, in particular by means of a base effect (lower employment rate and higher unemployment rate).

Despite the increase in the unemployment rate, the impact of the negative shock on public expenditure is relatively limited. The alternative scenario is developed under the assumption of “unchanged policies”, i.e. the public expenditure programmes are not adapted according to the economic slowdown. It should, however, be pointed out that in the case of an unexpected economic slowdown, the Government stands ready to take all the necessary measures, in particular regarding public expenditures, to contain the deterioration of the net lending capacity of the general government.

In terms of public revenue, the negative financial shock will have a direct and immediate impact on subscription tax revenues. The slowdown in total employment will have a negative impact on the development of personal income tax revenues – in particular withholding tax on wages and salaries – and on the development of social contributions. As a result of the base effects identified above, these negative effects on revenues will appear from 2008 onwards but persist in 2009 and 2010. Furthermore, the economic slowdown will have a negative effect on the path of the other direct and indirect taxes, such as corporate income tax or valued added tax, the development of which is determined by the economic activity.

Consequently, the negative external shock will lead to a deterioration in the net lending capacity of the general government amounting to 0.25% of GDP in 2008 and to 0.3% of GDP in 2009 and in 2010.

The general government budget balance will nevertheless remain positive and approach 1% of GDP in 2010. Furthermore, a sufficient safety margin will be maintained at all times to avoid exceeding the reference value of 3% of GDP.

IV.2. Comparison with previous stability programme

Economic growth in 2007 is more robust than what was anticipated in the autumn of 2006, when the previous stability and growth programme update was prepared. Indeed, while initially assuming 4% growth in 2007, economic growth is forecast to be close to 6%. This unexpected acceleration in economic growth essentially reflects a more favourable international environment – in particular over the course of the two first quarters – with the confirmation of a robust growth in the eurozone. It should be furthermore pointed out that the negative impact on growth and inflation triggered by the increase in VAT in Germany on 1 January 2007 was clearly less pronounced than anticipated by the great majority of forecasters. As a result of the very close economic ties between Luxembourg and Germany, this factor played a significant role in explaining the unexpected improvement of the economic environment in 2007.

Following the recent financial turbulences leading to a downwards revision of the growth prospects of the world economy in general and the European economy in particular in a context of increased downside risks, the growth forecast for the year 2008 has been revised downwards to 4.5%, i.e. -0.5% in relation to the growth forecast outlined in the previous stability programme update.

For the year 2009, the growth forecast has been raised by one percent to 5%, reflecting an international environment which, following financial turbulences having a negative yet time-limited effect on the world economy, remains generally favourable.

In matters of public finances, the comparison with the previous stability programme is very favourable, to the extent that the budget balances outlined in the current update are markedly better than those outlined in the previous update and that Luxembourg has already achieved its medium-term budgetary objective.

For the year 2006, the budget balance has improved by 2.2% of GDP in relation to the previous update. Despite a more robust economic growth than forecast, the improvement of the budget balance essentially reflects the result of rigorous control of public expenditure growth at general

government level. Indeed, compared with the previous stability programme update, public revenue has been revised downwards by 0.8% of GDP while public expenditure has been revised downwards by 3% of GDP. The downwards revision of public revenues essentially reflects direct taxes (-0.3% of GDP) and social contributions (-0.6% of GDP) that are lower than anticipated. The negative effect of the lower than anticipated social contributions, however, is more than compensated for by the expenditure of social transfers markedly below forecast (-0.9% of GDP, all categories combined). Other expenditure categories, such as employee compensation, public consumption and public investment, have also developed less rapidly than forecast. At the level of the sub-sectors, the improvement of the general government budget balance reflects in particular the central government budget balance, which has gone from -3.1% of GDP in the previous update to -0.9% of GDP in the present update of the stability programme.

The forecast of the net lending capacity of the general government in 2007 amounts to 1% of GDP, i.e. an upwards revision of 1.9% in comparison with the previous stability programme. As was the case in 2006, the present stability programme update sees public revenues as well as public expenditure being revised downwards. The downwards revision of public revenues amounts to 0.7% of GDP, essentially reflecting a downwards adjustment of the collected social contributions (-0.7% of GDP). It should be noted that the forecast concerning the tax revenues coincides in both programmes. The downwards revision of the social contributions is once again more than compensated for by the drop in expenditure in social transfers (-1.4% of GDP, all categories combined). Furthermore, the operating expenditure (employee compensation, intermediate consumption) and investment spending are lower than forecast in the previous stability programme update. At the level of general government sub-sectors, the financial situation of social security has improved slightly in comparison with the previous stability programme, while the central government deficit has gone from 2.9% of GDP in the previous programme to 0.9% of GDP in the present update.

The upwards revisions of the general government budget balances for the years 2008 and 2009 are lower than those for 2006 and 2007. They amount to +1.2% of GDP in 2008 and to +0.9% of GDP in 2009 in comparison with the previous stability programme. The reasons underlying this are essentially the same as for the years 2006 and 2007: the public revenues are lower than forecast, but this negative effect is more than compensated for by a greater control of public expenditure. It should be pointed out that at the level of public revenues, the present update takes into account the adaptation to inflation of the personal income tax rate and the introduction of a tax credit for children. These measures, which will enter into force on 1 January 2008, are new measures, which had not yet been adopted at the time when the previous stability programme update was drawn up. Furthermore, social contributions have also been revised downwards for 2008 and 2009, taking into account their over-estimation in the previous stability programme update. On the public expenditure side, the less dynamic than anticipated development of current public expenditure and social transfers in 2006 and 2007 has been integrated into the forecast for the present stability

programme update. It should be noted, however, that investment spending has not been adjusted downwards to the same extent that current expenditure has. At the level of the sub-sectors, the social security budget balance has improved by 0.2% of GDP in 2008 and 2009 while the improvement in the central government balance amounts to 0.9-1.4% of GDP in comparison with the previous update.

In comparison with the previous stability programme update, the forecast regarding the development of public debt has also been revised downwards, amounting to 0.9%-1.4% of GDP per year over the course of the 2006-2009 period. At the rate of 0.3-0.5% of GDP per year, this revision can be explained by a base effect linked to the upwards revision of the level of nominal GDP. Furthermore, the downwards revision of the public debt is to be seen in direct relation to the net borrowing requirement of the general government, which is lower than forecast during the period under examination.

V. Quality of public finances

In order to fully assess the global situation of Luxembourg's public finances, it is not sufficient to only examine the budgetary balance or public debt, which remains at a very low level, without taking into account the existence of central government (and social security) reserves. These reserves were built up during the period of rapid economic growth that yielded a string of large budget surpluses, which in turn were not reinjected into the budgetary circuit and therefore not used for the financing of current expenditures.

The general account (*compte général*), which closes at the end of the fiscal year, provides detailed information regarding the financial resources of central government. The Government's general accounting plan matches resources to their uses, hence providing the possibility of establishing the patrimonial situation of the Government in the form of a financial statement.

On 30 September 2007, this statement read as follows:

Resources (liabilities):

| | |
|--|----------------|
| • Government's own resources (special funds resources and budgetary reserve) | €1,931 million |
| • Government's own resources corresponding to financial fixed assets acquired by budgetary expenditure | €1,634 million |
| • Third party assets deposited with the Government | €435 million |
| • Third party assets borrowed by the Government (gross public debt) | €754 million |

Uses (assets):

| | |
|-----------------------------|----------------|
| • Bank financial assets | €2,531 million |
| • Non-bank financial assets | €1,634 million |
| • Balance (net borrowing) | €589 million |

In addition to borrowed funds, the Government has its own funds in the form of reserves. These reserves correspond to the cumulative sum of the net budget surpluses realised since 1944.

These reserves are essentially transferred to the different special government investment funds and are used to achieve the specific objectives for which each special fund was set up via a special law. Over the course of a fiscal year, the resources available in the special funds fluctuate due, on the one hand, to the inflow of budgetary endowments and, on the other hand, to the outflow relating to payments for work completed. At the end of September 2007, resources available in the special funds amounted to €1,461 million.

The special investment funds are typically used to finance projects that by their very nature are not appropriate to be dealt with via the ordinary budget. In fact, these are typically large investment projects that take several years to complete and where the relevant expenditures are spread out over several fiscal years.

Given that expenditures of the special funds are not tied to a specific fiscal year and funds available at the end of a fiscal year can be carried over to the next, this allows the Government to build up reserves in the special funds that can be used to finance future investment projects.

Due to the existence of these sizeable reserves, the budget is less sensitive to fluctuations in economic activity. Furthermore, the existence of the reserves allows the Government to maintain a high level of investment spending, even when the economy is slowing down. Consequently, the future central government deficits forecast in this update are offset by the existing reserves.

The balance of these reserves constitutes a free reserve, the budgetary reserve. At the end of September 2007, it amounted to €470 million. This reserve, the fluctuations of which depend on the central government balance, is used to ensure that the financial situation of central government is balanced, for instance in circumstances where revenues decrease due to an economic slowdown.

The existence of this budgetary reserve provides additional degrees of freedom to the Government to react to a deterioration of the financial situation of central government without having to use alternative channels, e.g. issuing new debt or increasing the tax burden.

Furthermore, the Government has occasionally acquired financial assets via participations or loans. At the end of September 2007, the value of these assets amounted to €1,634 million, well below the market value. The accounting counterpart of these assets increases the Government's own resources.

The sum of the Government's own resources, borrowed funds and third party assets deposited with the Government are invested in a variety of bank and non-bank financial assets, and the returns that they yield represent an additional source of income for the Government.

The difference between the assets and liabilities, amounting to €589 million at the end of September 2007, represents net government borrowing and is equivalent to the amount of uncovered public debt (Treasury bills and loans).

VI. Long-term sustainability of public finances

The general government budgetary situation returned to balance in 2006 and surpluses amounting to 0.8-1.2% of GDP are forecast to be maintained in 2007-2010. Furthermore, Luxembourg has achieved its medium-term budgetary objective and public debt is among the lowest in all of the European Union (6.9% of GDP in 2007).

Luxembourg has thus freed up a sufficient budgetary security margin to offset possible unexpected negative shocks and the ability to allow automatic stabilisers to work freely remains unaffected.

In order to preserve the reaction capacity of the fiscal policy and while taking into account the high degree of volatility of the public revenues characteristic of a small economy with a high degree of openness, it is imperative to closely watch the development of public expenditure. The existence of a budgetary adjustment capacity at expenditure level enables the maintenance or the regaining of the balanced budgetary position without resorting to an increase in tax burden. This is an essential factor for maintaining the attractiveness of Luxembourg as a centre of economic activity. In 2004-2007, Luxembourg demonstrated the existence of such adjustment capacities, enabling the solidity of public finances to be preserved in the short and medium term. In the longer term, the challenge of assuring budgetary sustainability proves more audacious.

The low level of public debt and the existence of significant financing reserves of the pension system (> 25% of GDP) imply that Luxembourg exhibits relatively favourable starting conditions to tackle the economic and budgetary challenges associated with demographic ageing.

Nevertheless, the long-term projections prepared in 2005 by the *Inspection générale de la sécurité sociale* (IGSS) in the context of the work undertaken by the Economic Policy Committee of the European Union and the European Commission show that, with unchanged policies, public expenditures linked to demographic ageing will experience a sharp increase from 2015/2020 onwards and place a considerable burden on the long-term sustainability of public finances.

The forecasts are based on the assumption of potential growth, which will slow down from the current rate of approximately 4% to one of 3% from 2015 onwards, and on a constant rate of unemployment of 4.2%. Following the demographic ageing process, the portion of the population of a working age will decrease from the current 67% to 61% in 2040-2050. In parallel, the ratio of the “inactive workforce” will increase from the current 21% to 36% in 2040-2050. The forecasts are furthermore based on the assumption of an increase in the participation rate in general, and, more particularly, of an increase in the participation rate of older workers from a current 32% to 42% in 2040-2050.

For the projection period, expenditures in relation to population ageing (pensions, health care, education, unemployment) will undergo a strong increase. The weight of these expenditures in GDP will increase from 19.5% over the course of the 2004-2010 period to more than 27% over the course of the 2040-2050 period, i.e. an increase amounting to 8% of GDP. The key factor in this increase is linked to pension expenditures (private and public sectors combined). In fact, according to these projections, the share in GDP of pension expenditures will increase by $\geq 7\%$ of GDP by 2040-2050.

Social contributions will undergo a moderate rise between 2006 and 2050. Nevertheless, pension reserves will continue to increase until 2020 to reach approximately 40% of GDP. With unchanged policies, the social security budget balance will become negative around 2025 and pension reserves will start gradually to erode. Indeed, in 2035 these reserves will have disappeared and the social security deficit will have to be financed by an increase in public debt.

Assuming that the medium-term budgetary objective of a structural balance of -0.8% of GDP will be achieved in 2010, long-term projections of the European Commission forecast that the debt ratio will go from the current $< 10\%$ of GDP to $> 200\%$ of GDP around 2050. Furthermore, the threshold of 60% of GDP foreseen in Article 104 of the CE Treaty will be exceeded before 2030. It should be pointed out that the medium-term budgetary objective has already been achieved in 2006 and that over the course of the 2007-2010 period, the general government is forecast to free up a net lending capacity in nominal terms. This has consequences for the developments of public debt, which will increase, but at a slower rate than anticipated in these long-term projections.

The projections show that adjustments will need to be envisaged in the medium term to ensure the sustainability of public finances in general and to maintain the financial viability of the social security system. In order to guarantee that Luxembourg will be ready to tackle the consequences of demographic ageing, the Tripartite Coordinating Committee concluded in April 2006 that “the social partners and the Government will proceed with the creation of a discussion group, which will have as its mission the drawing up of recommendations to ensure the long-term sustainability of the pension system and the studying of various measures that can be envisaged in order to guarantee this long-term sustainability and to adapt the pension system to developments linked to changes in the unfolding of professional careers, demographic ageing and its impact on working life spans.” A first meeting of this discussion group has been set for November 2007.

VII. Institutional features of public finances

The legal framework of the institutional features of public finances is laid down by the Law of 8 June 1999 on the State Budget, Public Accounts and the Treasury.

The Law of 8 June 1999 involved an overhaul of the central government budgetary and accounting system by foreseeing in particular the improvement of the regulations of budgetary accounting, the possibility of granting certain public services greater financial autonomy and the creation of the *Direction du contrôle financier* (DCF).

The creation of the *Direction du contrôle financier* reinforced the coordination and the monitoring of the public expenditure control mission. Financial controllers are placed throughout the different ministerial departments where they perform their control missions. They carry out their mission with a certain degree of independence, to the extent that they are not supposed to receive instructions regarding specific files. The control mission of the financial controllers is an *ex ante* mission, meaning that the compliance of the expenditure with all applicable decisions and regulations is verified prior to the commitment of said expenditure.

Nevertheless, the surveillance mission of the *Direction du contrôle financier* does not cover aspects relating to the appropriateness and effectiveness of public expenditure. This mission in turn is entrusted to the *Inspection générale des Finances*, which is furthermore responsible for drawing up the draft bill regarding the State revenue and expenditure budget.

The governmental programme of August 2004 foresees additional adaptations at the level of budgetary procedures: “Given that the annual procedure of preparing the State budget constitutes an essential factor in the control of public finances, the Government shall, from the 2005 fiscal year onwards, proceed with an overhaul of the current budgetary procedure, which will translate in particular to the postponement of the approval of the draft budget at governmental level from the month of August to the month of October. By thus bringing the adoption of the draft budget closer to the year that it relates to, the quality of budgetary forecasts will be further improved as a result of being able to better take into account the updated economic forecasts of the international and national forecasting bodies in the budgetary context. Abolishing the procedure of budgetary amendments to be introduced at a later stage by the Government will furthermore allow a greater concentration of available resources on the exhaustive analysis of budget provision requests and on the multi-annual planning of State investments.”

The new budgetary procedure has been implemented since the preparation of the 2005 draft budget, pursuant to the principles outlined in the governmental programme of August 2004.

Furthermore, the governmental declaration of August 2004 foresees that “any direct and indirect investment projects of the State shall be submitted to a more detailed analysis and procedure with the aim of reducing the cost of public investments. More particular attention shall also be paid, from the planning phase onwards, to an assessment of the running and operating costs of the new infrastructures in a bid to control the evolution of State operating expenditure.”

In April 2006, a new procedure concerning the preparation and presentation of large-scale infrastructure projects was adopted by the *Commission du Contrôle de l'exécution budgétaire et des Comptes de la Chambre des Députés*. It foresees in particular that any significant change in programme arising after the vote of an authorisation law must be subjected to a new assessment by Parliament and that any exceeding of the authorised budget for implementation will necessarily result in the presentation of a new government bill in the event that said budgetary overrun is exceeding 5%.

The Government has also launched a pilot scheme in the area of public-private partnership (PPP) involving the construction of public infrastructures, in a bid to achieve a reduction in construction timeframes as well as in the global cost of the projects in question.

The budgetary procedure starts with the budgetary circular being forwarded by the Minister for the Treasury and the Budget to all the ministerial departments. The budgetary circular includes guidelines of a political nature (e.g. budgetary strategy and objectives) and of a technical nature (e.g. macroeconomic assumptions, growth rate ceilings according to category of public expenditure) to be observed by the ministerial departments when drawing up their budgetary proposals. The budgetary circular regarding the 2008 draft budget was distributed to the ministerial departments on 16 April 2007.

In May, the broad guidelines of the governmental policy are presented to Parliament by the Prime Minister in the context of the declaration by the Government on the country's economic, social and financial situation.

Following the presentation of the political priorities of governmental action and the justification of the budgetary priorities of the ministerial departments pursuant to the broad guidelines, in August the Minister for the Treasury and the Budget enters into bilateral discussions with the other members of the Government and the draft budget is finalised at government level towards the end of September.

At the beginning of October, the draft budget is submitted to Parliament. The presentation of the 2008 draft budget took place on 10 October 2007.

The presentation of the government bill regarding State revenue and expenditure for the 2008 fiscal year was marked by a certain number of innovations in a bid to increase the transparency of public finances. Indeed, volume II of the draft budget entitled “multi-annual capital spending programme 2007-2011” was submitted to Parliament at the same time as the actual draft budget. In the past, the multi-annual capital spending programme has not been available until mid-November. Furthermore, the draft budget for the 2008 fiscal year was accompanied by a new volume III outlining in a detailed manner the transition from the “working balance” of the different general government sub-sectors to the budget balance of the sub-sectors established in accordance with the regulations and concepts of the stability programme (ESA95). Finally, the delay between the presentation of the draft budget and the presentation of the stability programme has been significantly shortened in order to allow Parliament to include the assessment of the draft budget for the year ahead within the broader context of medium-term and long-term budgetary planning.

ANNEXES:

Table 1a: Macroeconomic forecast

| | ESA Code | 2006 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-------------|-----------|------|------|------|------|------|
| | | € billion | % | % | % | % | % |
| 1. Real GDP | B1*g | 28.0 | 6.1 | 6.0 | 4.5 | 5.0 | 4.0 |
| 2. Nominal GDP | B1*g | 33.9 | 12.7 | 10.6 | 7.6 | 7.3 | 6.7 |
| Growth sources: constant price variation | | | | | | | |
| 3. Private consumption expenditure | P.3 | 10.7 | 2.1 | 1.8 | 2.4 | 3.0 | 2.1 |
| 4. Government consumption expenditure | P.3 | 4.2 | 2.1 | 2.2 | 3.8 | 2.1 | 2.9 |
| 5. Gross fixed capital formation | P.51 | 5.8 | 3.1 | 9.6 | 6.6 | 4.5 | 2.9 |
| 6. Changes in inventories (in % of GDP) | P.52 + P.53 | 0.2 | 0.6 | -0.5 | -0.2 | -0.1 | -0.1 |
| 7. Exports of goods and services | P.6 | 47.2 | 9.6 | 10.3 | 6.9 | 8.2 | 7.8 |
| 8. Imports of goods and services | P.7 | 40.1 | 7.2 | 9.3 | 7.2 | 8.0 | 7.7 |
| Contribution to GDP growth | | | | | | | |
| 9. Total final domestic demand | | ... | 1.8 | 3.1 | 2.9 | 2.4 | 1.8 |
| 10. Changes in inventories | P.52 + P.53 | ... | -1.1 | -1.0 | 0.3 | 0.1 | 0.1 |
| 11. External balance of goods and services | B.11 | ... | 5.5 | 4.0 | 1.3 | 2.5 | 2.1 |

Table 1b: Price developments

| | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|--|----------|------|------|------|------|------|
| | | % | % | % | % | % |
| 1. GDP deflator | | 6.2 | 4.3 | 3.0 | 2.2 | 2.6 |
| 2. Private consumption deflator | | 2.9 | 2.2 | 2.3 | 2.2 | 2.2 |
| 3. Inflation rate (HICP) | | 3.0 | 2.3 | 2.0 | 2.1 | 2.1 |
| 4. Public consumption deflator | | 1.8 | 4.3 | 3.9 | 4.3 | 3.4 |
| 5. Investment deflator | | 0.5 | -0.3 | 1.7 | 1.7 | 1.7 |
| 6. Export price deflator (goods and services) | | 9.4 | 6.2 | 4.1 | 4.9 | 4.8 |
| 7. Import price deflator (goods and services) | | 7.9 | 7.0 | 3.9 | 5.7 | 5.1 |

Table 1c: Labour market developments

| | ESA Code | 2006 | 2006 | 2007 | 2008 | 2009 | 2010 |
|--|----------|---------|------|------|------|------|------|
| | | Figures | % | % | % | % | % |
| 1. Domestic employment, persons (in thousands) | | 319.1 | 3.7 | 4.1 | 3.9 | 3.7 | 3.6 |
| 2. Employment, hours worked | | ... | 2.8 | 4.8 | 3.7 | 3.6 | 3.4 |
| 3. ILO unemployment rate (%) | | ... | 4.8 | 4.9 | 4.7 | 4.6 | 4.6 |
| 4. Labour productivity (real GDP per person employed) | | ... | 2.3 | 1.8 | 0.5 | 1.2 | 0.4 |
| 5. Labour productivity (real GDP per hour worked) | | ... | 3.2 | 1.2 | 0.7 | 1.4 | 0.6 |
| 6. Compensation of employees (€billion) | D.1 | 15.2 | 7.9 | 8.7 | 7.7 | 8.0 | 7.3 |
| 7. Compensation per employee (€1000 / year) | | 51.1 | 4.5 | 4.1 | 3.5 | 3.9 | 3.4 |

Table 1d: Sectoral balances

| in % of PIB | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|----------|------|------|------|------|------|
| 1. Net lending/borrowing vis-à-vis the rest of the world | B.9 | ... | ... | ... | ... | ... |
| <i>of which:</i> | | | | | | |
| Balance on goods and services | | 29.7 | 29.7 | 30.7 | 31.7 | 33.1 |
| Balance of primary incomes and transfers | | ... | ... | ... | ... | ... |
| Capital account | | ... | ... | ... | ... | ... |
| 2. Net lending/borrowing of the private sector | B.9 | ... | ... | ... | ... | ... |
| 3. Net lending/borrowing of general government | EDP B.9 | 0.7 | 1.0 | 0.8 | 1.0 | 1.2 |
| 4. Statistical discrepancy | | ... | ... | ... | ... | ... |

Table 2: General government budgetary situation

| in % of GDP | ESA Code | 2006 | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|-------------------------------|--------------------------------|----------------------------|------|------|------|------|
| | | € million | % | % | % | % | % |
| | | | Net lending of sub-sectors | | | | |
| 1. General government | S.13 | 233.5 | 0.7 | 1.0 | 0.8 | 1.0 | 1.2 |
| 2. Central government | S.1311 | -304.6 | -0.9 | -0.9 | -1.4 | -1.4 | -1.4 |
| 3. Regional government | S.1312 | ... | ... | ... | ... | ... | ... |
| 4. Local government | S.1313 | -66.4 | -0.2 | -0.1 | -0.1 | -0.1 | 0.0 |
| 5. Social security | S.1314 | 604.5 | 1.8 | 2.0 | 2.4 | 2.5 | 2.6 |
| | | General government (S.13) | | | | | |
| 6. Total revenue | TR | 13 434.6 | 39.7 | 38.5 | 37.8 | 37.9 | 37.8 |
| 7. Total expenditure | TE | 13 201.1 | 39.0 | 37.5 | 36.9 | 36.9 | 36.6 |
| 8. Budget balance | EDP B.9 | 233.5 | 0.7 | 1.0 | 0.8 | 1.0 | 1.2 |
| 9. Interest burden | EDP D.41 | 56.9 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| 10. Primary balance | | 290.4 | 0.9 | 1.2 | 1.1 | 1.2 | 1.5 |
| 11. One-off and temporary measures | | 115.0 | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| | | Main components of revenue | | | | | |
| 12. Taxes (12=12a+12b+12c) | | 8 574.0 | 25.3 | 24.4 | 23.6 | 23.6 | 23.5 |
| 12a. Taxes on production and imports | D.2 | 4 157.7 | 12.3 | 11.7 | 11.2 | 11.2 | 11.2 |
| 12b.+12c. Current taxes on income and wealth and taxes on capital | D.5+D.91 | 4 416.3 | 13.0 | 12.7 | 12.4 | 12.4 | 12.3 |
| 13. Social contributions | D.61 | 3 648.4 | 10.8 | 10.7 | 10.6 | 10.6 | 10.6 |
| 14. Property income | D.4 | 475.2 | 1.4 | 1.4 | 1.5 | 1.6 | 1.6 |
| 15. Other revenue | | 737.0 | 2.2 | 2.1 | 2.0 | 2.1 | 2.1 |
| 16.=6. Total revenue | TR | 13 434.6 | 39.7 | 38.5 | 37.8 | 37.9 | 37.8 |
| p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) | | ... | 36.1 | 35.0 | 34.2 | 34.2 | 34.1 |
| | | Main components of expenditure | | | | | |
| 17. Employee compensation and intermediate consumption | | 3 546.2 | 10.5 | 10.2 | 10.0 | 9.8 | 9.8 |
| 17a. Employee compensation | D.1 | 2 500.5 | 7.4 | 7.1 | 7.1 | 7.0 | 6.9 |
| 17b. Intermediate consumption | P.2 | 1 045.7 | 3.1 | 3.0 | 2.9 | 2.8 | 2.9 |
| 18. Social transfers (18=18a+18b) | | 6 197.8 | 18.3 | 17.3 | 17.1 | 17.1 | 16.9 |
| 18a. Social transfers in kind | D.6311, D.63121, D63131 | 1 593.2 | 4.7 | 4.5 | 4.8 | 4.8 | 4.9 |
| 18b. Social transfers in cash | D.62 | 4 604.5 | 13.6 | 12.8 | 12.4 | 12.3 | 12.0 |
| 19.=9. Interest expenditure | EDP D.41 | 56.9 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| 20. Subsidies | D.3 | 518.1 | 1.5 | 1.5 | 1.4 | 1.4 | 1.4 |
| 21. Gross fixed capital formation | P.51 | 1 348.4 | 4.0 | 4.0 | 3.9 | 4.3 | 4.3 |
| 22. Other expenditure | | 1 533.8 | 4.5 | 4.4 | 4.3 | 4.1 | 4.0 |
| 23.=7. Total expenditure | TE | 13 201.1 | 39.0 | 37.5 | 36.9 | 36.9 | 36.6 |
| p.m. Public consumption (in nominal terms) | P.3 | 5 193.9 | 15.3 | 14.7 | 14.3 | 14.2 | 14.0 |

Table 3: General government expenditure by function

| in % of GDP | COFOG Code | 2005 | 2010 |
|-------------------------------------|------------|------|------|
| 1. General public services | 1 | 4.6 | ... |
| 2. Defence | 2 | 0.2 | ... |
| 3. Public order and safety | 3 | 1.0 | ... |
| 4. Economic affairs and services | 4 | 4.3 | ... |
| 5. Environmental protection | 5 | 1.1 | ... |
| 6. Housing and community amenities | 6 | 0.8 | ... |
| 7. Health | 7 | 5.3 | ... |
| 8. Recreation, culture and religion | 8 | 2.2 | ... |
| 9. Education | 9 | 4.9 | ... |
| 10. Social protection | 10 | 17.4 | ... |
| 11. Total expenditure | TE | 41.8 | 36.6 |

Table 4: Public debt

| in % of GDP | ESA Code | 2006 | 2006 | 2007 | 2008 | 2009 | 2010 |
|--------------------------------------|----------|--|-------|-------|------|------|------|
| | | € million | % | % | % | % | % |
| 1. Gross debt | | 2 242.1 | 6.6 | 6.9 | 7.1 | 7.2 | 7.0 |
| <i>including:</i> | | | | | | | |
| Central government | | 1 466.6 | 4.3 | 4.5 | 4.8 | 5.0 | 4.9 |
| Local government | | 775.5 | 2.3 | 2.4 | 2.3 | 2.2 | 2.1 |
| Social security | | 0.0 | 0 | | | | |
| 2. Change in gross debt ratio | | ... | 0.4 | 0.2 | 0.2 | 0.1 | -0.2 |
| | | Elements contributing to gross debt development | | | | | |
| 3. Primary surplus | | 290.4 | 0.9 | 1.2 | 1.1 | 1.2 | 1.5 |
| 4. Interest expenditure | EDP D.41 | 56.9 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| 5. Stock-flow adjustment | | ... | 1.8 | 1.9 | 1.6 | 1.5 | 1.4 |
| p.m.: implicit interest rate | | ... | 3.0 | 3.5 | 3.4 | 3.9 | 4.3 |
| | | Other relevant variables | | | | | |
| 6. Liquid financial assets | | 11 658.6 | 34.4 | 33.9 | ... | ... | ... |
| 7. Net debt | | 9 416.5 | -27.8 | -27.0 | ... | ... | ... |

Table 5: Cyclical developments of public finances

| in % of GDP | ESA Code | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|----------|------|------|------|------|------|
| | | % | % | % | % | % |
| 1. Real growth in GDP (%) | | 6.1 | 6.0 | 4.5 | 5.0 | 4.0 |
| 2. Net lending/borrowing of general government | EDP B.9 | 0.7 | 1.0 | 0.8 | 1.0 | 1.2 |
| 3. Interest expenditure | EDP D.41 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 |
| 4. One-off and temporary measures | | 0.3 | 0.0 | 0.0 | 0.0 | 0.0 |
| 5. Potential GDP growth rate (%) | | 4.7 | 4.6 | 4.6 | 4.6 | 4.6 |
| 6. Output gap | | -0.9 | 0.4 | 0.3 | 0.7 | 0.2 |
| 7. Cyclical budgetary components | | -0.4 | 0.2 | 0.1 | 0.3 | 0.1 |
| 8. Cyclically-adjusted budgetary balance | | 1.1 | 0.8 | 0.7 | 0.6 | 1.1 |
| 9. Cyclically-adjusted primary balance | | 1.3 | 1.0 | 0.9 | 0.9 | 1.4 |
| 10. Structural balance | | 0.8 | 0.8 | 0.7 | 0.6 | 1.1 |

Table 6: Divergences from previous programme update

| | ESA Code | 2006 | 2007 | 2008 | 2009 |
|--|----------|------|------|------|------|
| Growth in GDP (%) | | | | | |
| 8th update | | 5.5 | 4.0 | 5.0 | 4.0 |
| 9th update | | 6.1 | 6.0 | 4.5 | 5.0 |
| Difference | | 0.6 | 2.0 | -0.5 | 1.0 |
| Net lending/borrowing of general government (in % of GDP) | EDP B.9 | | | | |
| 8th update | | -1.5 | -0.9 | -0.4 | 0.1 |
| 9th update | | 0.7 | 1.0 | 0.8 | 1.0 |
| Difference | | 2.2 | 1.9 | 1.2 | 0.9 |
| General government gross debt (in % of GDP) | | | | | |
| 8th update | | 7.5 | 8.2 | 8.5 | 8.5 |
| 9th update | | 6.6 | 6.9 | 7.1 | 7.2 |
| Difference | | -0.9 | -1.3 | -1.4 | -1.3 |

Table 7: Long-term sustainability of public finances

| in % of GDP | 2004 | 2010 | 2015 | 2020 | 2030 | 2040 | 2050 |
|---|------|------|------|------|------|-------|-------|
| General government expenditure | 42.5 | 36.6 | ... | ... | ... | ... | ... |
| <i>including: expenditure related to demographic ageing</i> | 19.5 | 19.4 | 20.5 | 21.6 | 25.0 | 27.4 | 27.8 |
| Pension expenditure | 10.0 | 9.8 | 10.9 | 11.9 | 15.0 | 17.0 | 17.4 |
| Health | 5.1 | 5.3 | 5.4 | 5.6 | 5.9 | 6.2 | 6.3 |
| Long-term care insurance | 0.9 | 1.0 | 1.0 | 1.0 | 1.1 | 1.3 | 1.5 |
| Education | 3.3 | 3.1 | 2.9 | 2.8 | 2.7 | 2.6 | 2.4 |
| Other expenditure related to demographic ageing | ... | ... | ... | ... | ... | ... | ... |
| Unemployment benefits | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 |
| Interest expenditure | 0.1 | 0.3 | ... | ... | ... | ... | ... |
| Total revenue | 41.7 | 37.8 | ... | ... | ... | ... | ... |
| <i>including: property income</i> | 1.1 | 1.6 | ... | ... | ... | ... | ... |
| <i>including: social contributions</i> | 11.4 | 10.6 | ... | ... | ... | ... | ... |
| Reserves of pension funds | 23.6 | 31.7 | 37.4 | 39.2 | 17.9 | 0.0 | 0.0 |
| General government gross debt | 6.4 | 7.0 | 15.2 | 26.6 | 73.6 | 150.0 | 240.0 |
| Assumptions | | | | | | | |
| Labour productivity developments | 1.1 | 2.3 | 2.1 | 2.0 | 1.7 | 1.7 | 1.7 |
| Economic growth | 3.9 | 4.0 | 3.2 | 2.7 | 3.0 | 3.0 | 3.0 |
| Participation rate (men, 15-64) | 75.7 | 75.6 | 75.4 | 75.0 | 74.3 | 75.1 | 74.8 |
| Participation rate (women, 15-64) | 55.1 | 58.6 | 60.1 | 60.8 | 61.3 | 62.0 | 61.7 |
| Total participation rate (15-64) | 65.5 | 67.2 | 67.8 | 67.9 | 67.9 | 68.6 | 68.3 |
| Unemployment rate | 3.8 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 | 4.2 |
| Inactive/active ratio (65+/15-64) | 21.0 | 21.6 | 22.8 | 24.7 | 31.6 | 36.7 | 36.1 |

Table 8: Basic assumptions

| | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|------|------|------|------|------|
| Short-term interest rate in €(annual average) | 3.1 | 4.3 | 4.2 | 4.1 | 4.0 |
| Long-term interest rate in €(annual average) | 3.9 | 4.2 | 4.2 | 4.3 | 4.4 |
| Exchange rate USD/€ (annual average) | 1.25 | 1.35 | 1.38 | 1.38 | 1.38 |
| Nominal effective exchange rate | -0.1 | -0.5 | -0.2 | -0.0 | -0.0 |
| World GDP growth excluding EU | | | | | |
| Economic growth eurozone | 2.7 | 2.7 | 2.0 | 2.2 | 2.1 |
| Economic growth of relevant foreign markets | 7.6 | 7.0 | 5.4 | 6.2 | 5.0 |
| World import volume growth (excluding EU) | ... | ... | ... | ... | ... |
| Oil prices (USD) | 65.2 | 69.5 | 76.7 | 76.7 | 76.7 |