

# Luxembourg

<b>Prime Minister:</b> Jean-Claude JUNCKER	<b>Population</b> (2007 est.): 476,187
<b>Finance Minister:</b> Jean-Claude JUNCKER	<b>GDP</b> (2007): €36.1 billion
<b>Central Bank Governor:</b> Yves MERSCH	<b>GDP/capita:</b> €75,200
<b>Joined the EU:</b> 1957	<b>GDP by sector:</b>
<b>Adopted the Euro:</b> 1999	Agriculture 1%
<b>Currency prior to Euro:</b> Luxembourg Franc	Industry 13%
	Services 86%
	<b>Life Expectancy</b> (women / men): 82 / 77
	<b>2005      2006      2007      2008*</b>
<b>Real GDP growth rate</b>	5.2%    6.4%    5.2%    2.5%
<b>Inflation</b>	3.8%    3.0%    2.7%    4.4%
<b>Unemployment Rate</b>	4.6%    4.6%    4.1%    4.0%

\* forecast

## Luxembourg in the EU and the Euro Area

Luxembourg was one of the first six Member States of the EU. In 1957 it joined what was then called the European Economic Community (EEC or "Common Market"). In 1948, it had been a founding member of the "Benelux" customs union (an area of reduced/extinguished tariffs on trade), together with Belgium and the Netherlands. Some people regard the Benelux customs union as a precursor to the EU.

Luxembourg was also one of the founding members of the euro area. It adopted the euro on 1 January 1999, the official launch date of the single currency. Euro notes and coins were introduced on 1 January 2002, replacing the Luxembourg franc.

## Economic Overview of Luxembourg

In the past, Luxembourg's economy was largely based on iron and steel production. Today, Luxembourg has a services-based economy, and financial services (e.g. banking, insurance) play a dominant role, accounting for around one-third of all economic activity. Light manufacturing and other services have also flourished, helping to generate very strong growth in both output and employment over the last twenty years. Luxembourg's favorable regulatory and tax environment have helped it attract foreign investment. And high salaries (and low labor taxes) have encouraged foreign workers to come to work in Luxembourg.

The country is also known for a tradition of "social dialogue" and for its generous welfare system. In per capita terms, social spending (on pensions, unemployment benefits and family benefits) is the highest in the EU. The economy's strong growth performance in the 1980s and 1990s enabled it to generate sharp increases in social expenditure starting in the mid-1990s.

Luxembourg is also distinctive in having low taxation of labor income (i.e. low rates of income tax and social security contributions) by European standards. Luxembourg is the smallest euro area economy, accounting for only 0.4 per cent of total euro area GDP. It also has the highest GDP per capita in the world, at over €75,000. In part, the high GDP per capita number is a reflection of the very large number of cross-border workers, who contribute to the country's GDP but not to its population. But it also reflects the strong economic growth that the economy experienced in recent decades as it successfully moved out of heavy manufacturing (steel) towards services, and financial services in particular.

### Some Economic Challenges Facing Luxembourg

GDP per capita, adjusted for cross-border workers, has accelerated again from a level that is already one of the highest in OECD countries. However, labor force participation of some groups remains low and productivity growth is weak.<sup>1</sup>

#### *Future Growth Prospects*

Luxembourg experienced strong growth of both output and employment over the last twenty years. However, its future growth prospects are less favorable due to a number of factors. The crisis on the financial markets and the global slowdown in growth will certainly take their toll on Luxembourg too: exports of goods will suffer from the global slowdown in the world economy, exports of services are likely to post negative growth rates in 2009, reflecting the decline in the activity of the financial sector, and so will private investment. The country's financial sector has been a key contributor to economic growth. As the sector is already quite mature, future growth in financial services will be lower than in the past. In addition, population ageing will have an impact on Luxembourg's long-term potential growth rate and Luxembourg faces intensified international competition from newly emerging economies.

#### *Population Ageing*

Due to the impact of demographics, the economy's growth rate is projected to decline from around 4% per annum in the period 2004-2010 to around 3% per annum in the period 2011-2050. The old-age dependency ratio (the ratio of retired people to people of working age) is projected to rise from 21% in 2004 to 36% in 2050. This is one of the smallest increases in the EU, reflecting the exclusion of cross-border workers from the calculation. But pension expenditure as a share of GDP is projected to increase sharply over coming decades. Luxembourg will need to address this challenge in order to ensure that its public finances are sustainable over the long term.

#### *Labor markets*

Unemployment among Luxembourg's resident population is rising. Many employers prefer to recruit cross-border workers who are willing to accept lower salaries than residents. Luxembourg's generous level of unemployment benefits may reduce the incentives of residents to look for work. At around 64%, Luxembourg's employment rate is close to the EU average, but is low in comparison to the US and is below the Lisbon target of 70% to be achieved by 2010. A particular problem facing Luxembourg is the much lower employment rates of older workers, children of immigrants and those from poor socio-economic backgrounds.

#### *Productivity growth*

While Luxembourg has a high level of labor productivity the growth of productivity has slowed recently. This could reflect a number of factors. Firstly, educational attainment is low by international standards, and is particularly low for children of immigrants and those from low

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<sup>1</sup> "Economic Reform: Going for Growth." OECD. 2008

socio-economic backgrounds. Secondly, barriers to competition may have restrained productivity growth (particularly because of anti-competitive practices by firms in professional services). Thirdly, research and development (R&D) policy is relatively under-developed in Luxembourg.