Note de conjocture 1-2004

Publication of 2003 Annual Report: Recovery in 2003 – improved outlook for 2004 and 2005.

STATEC has just published Note de Conjoncture No. 1-2004. The first issue of the year serves as an "Annual Economic Report": it paints a general picture of 2003 and supplies an update of the forecasts for 2004-2005. This issue deals in particular – and in depth – with the national and international economic situation, foreign trade, the labour market, inflation and wages. It includes additional chapters on activity within the sectors, the public finances, the demography of enterprises and new information and communication technologies. Detailed statistical appendices cover the main economic indicators, national accounts from 1985 to 2003, a list of principal enterprises and an exhaustive recent economic bibliography.

The main aspects

Initial appraisals of the national accounts for 2003 suggest that the Luxembourg economy developed more favourably than was forecast in autumn 2003. The 2001 and 2002 accounts have also been revised, resulting in a mean GDP growth figure over the last three years of 1.7%. This growth should be compared with the average for the years 1985-2000, which was 6.1%.

While the monthly and quarterly indicators at the end of 2003 and the beginning of 2004 remain – for the most part – generally favourable (with the notable exception of unemployment), the general economic situation is still suffering from the after-effects of the slowdown of 2001 and 2002. Adjustment by the different sections of the economy to more moderate GDP growth compared with the recent past – averaging around +3% in 2004 and 2005 – is bound to be a gradual process.

Hence, in terms of production factors, lower investment in tangible assets (machinery, equipment and buildings) is observed, whilst the number of persons employed continues to rise. However, average working hours have fallen significantly, by more than 1% over three years, whilst unemployment has soared. Companies are also trying to limit overheads which, at the macro-economic level, means virtual stagnation of "intermediate consumption", in the economic jargon.

Sectors which are primarily geared to internal demand (construction, trade) have generally come through the difficult period fairly well, but this is partly due to exceptional and non-recurrent factors such as the cut in direct taxes in Luxembourg, the rise in the price of products subject to excise duties abroad, lower interest rates and higher oil prices. In view of likely future curbs on public expenditure, spending should also adjust to a more moderate rate of expansion, and the same goes for areas that are heavily dependent on the public sector, such as health and welfare.

Even so, the Luxembourg economy should experience solid growth in 2004 of the order of 2.5%. It seems certain that the sectors geared to foreign markets (manufacturing, transport, communications etc.) will benefit from very buoyant global trade. Inflation should remain moderate – close to 2% – even if higher oil prices are delaying further deceleration. The labour market situation is unlikely to change. As in 2003, unemployment continues to climb. Therefore the increased demand for labour consequent upon the recovery could initially be met through longer working hours or by temporary working, a trend already started in 2003.

Performance in 2003

Activities by sectors

The year 2003 seems to have been a turning point for the Luxembourg economy. The various statistical data available at sector level indicate, if not an upturn, then at least a stabilisation (after a downturn), or a slowing of the downturn (after a sharp downturn).

Manufacturing and construction were the solid pillars of growth in 2003. From the beginning of the year, various statistical indicators relating to manufacturing showed a very positive tendency which was confirmed over the months. Output increased by 2.6% over the year as a whole, which was marked by very strong progress in industries linked to energy, and by a reduction, already very much in evidence in 2002, of the iron and steel industry. For construction, on the other hand, the first quarter gave out negative signals, particularly as regards residential building. Results greatly improved thereafter (in both residential and non-residential construction), and a catching-up process was observed over the remainder of the year. In this sector, the increase in value-added (in volume) is estimated at 4.7% over the year as a whole.

Trade benefited from being opened up to foreign markets, with turnover increasing by more than 8% (in volume) over the year as a whole, an excellent result compared with previous years. The increase was essentially due to wholesale trade and the automotive sector. However, it would be wrong to put this increase down to a greater appetite on the part of Luxembourg consumers (final consumption by resident households grew by only 1.2% in 2003, compared with 2.8% in 2002). This finding is backed up by the fact that retail trade, though it achieved a positive performance (+4.5%), was the only area to do less well than in 2002.

Hotel and catering businesses had a relatively difficult year. Although Luxembourg campsites had a good season, tourism rates were lower in 2003. The drop in what is known as "business tourism" seems to have been a particular problem. For many sectors – and the same is true throughout Europe – this is a time of continual cost-cutting and austerity in terms of everyday expenditure, and this has had a major impact on hotel and restaurant costs.

The transport sector reported luke-warm results in 2003. The number of passengers checked in at Luxembourg Airport fell by approximately 4% in 2003. This drop was offset to a certain extent by a very vigorous increase in freight. Land transport stagnated whilst waterway transport saw a drop in activity.

The financial sector benefited from the recovery in the financial markets which began in the second quarter of 2003. Though the available indicators give contrasting signals, partly due to technical or methodological factors, the talk among players in Luxembourg's financial markets is tinged with growing optimism. The major banking establishments were therefore able to publish results showing good progress over the year as a whole.

However, the stock market recovery and low interest rates do not explain everything. The improvement is also due to a pro-active policy on the part of those in charge – firstly to adapt to a fast-changing regulatory environment in a European context, and secondly to reduce personnel and operating costs. Regarding the second point, one is bound to note the negative impact in terms of jobs, though this is a generalised phenomenon affecting the sector throughout Europe.

Other business services have not yet truly recovered. The data published in the national accounts, which allows us to consider the volume of activity achieved during 2003 as a whole (i.e. to neutralise price variations) points to stagnation. The recovery seen in several other areas of the economy has still not really spread to these services, taken together. However, the various monthly indicators of activity provide more encouraging signs for certain of these services as of September 2003.

Foreign trade

The current account surplus fell from € 2.6 billion in 2002 to € 2.2 billion in 2003. Expressed as a percentage of GDP, the current balance in 2003 was close to that of the late 1990s, i.e. just below 10%. This deterioration is essentially due to worsening structural deficits in the balance of revenues and current transfers. On the other hand, the balance of goods and services improved slightly, reaching a surplus of € 5.3 billion, largely thanks to the positive balance on trade in services (€ 7.5 billion), which benefited in particular from the favourable performance of transport and travel activities and financial services.

Jobs and unemployment

The recovery in economic activity has not as yet, properly speaking, had any positive impact on jobs and unemployment. In fact, during the recovery phase, the economy generally goes through a three-stage process: firstly, companies return to profitability; then there is an investment recovery and finally employment recovers. 2003 accordingly saw continuing growth in unemployment, which, allowing for seasonal variations, increased throughout the year, most markedly during the second quarter. Since then it has continued to grow, but more slowly. At the beginning of 2004, the unemployment rate was 4.3% (number of people unemployed as a percentage of the active population), 0.7 of a percentage point above the level at the same time the previous year. Job growth stabilised at an annual rate of around 2%, a very low rate compared with previous years.

Prices and wages

Analysis of retail prices in 2003 reveals a slowing tendency, which is particularly noticeable in terms of the monthly figures for underlying inflation (reflecting the "sluggish" momentum) in the second half of the year and at the start of 2004. Furthermore, wage growth was relatively weak in 2003 (+1.9%) and should remain moderate in 2004. Wages (and by implication prices) are starting to show the effects – admittedly with a certain time-lag – of the rise in unemployment and a global economic situation which has been slow-moving since 2001 (compared with the boom years in the second half of the nineties). It is also worth noting that the impact of oil price rises has been alleviated by the moderating effects of the euro’s appreciation.

Public finances

The budget balance, as published in the national accounts under the requirements of the EU Treaty, showed a slight deficit (-0.1% of GDP). However, the structural balance, i.e. the balance after cyclical correction, is significantly positive. The trend of structural balances over the period from 2000 to 2004 indicates a somewhat anti-cyclical policy. This has allowed the deployment of “automatic stabilisers”, partially offsetting the economic slowdown.

Forecasts for 2004-2005

The international economic situation

International organisations, which have published their spring forecasts over the last few weeks, all agree that the international economic climate has improved considerably these last six months. Compared with its autumn 2003 forecasts, for example, the European Commission has raised its estimate of world economic growth in 2004 by 0.4 of a percentage point, from 4.1% to 4.5%.

It seems that the EU countries will benefit only moderately from this dynamism, even though the published figures for the first quarter of 2004 indicate very buoyant activity in Europe. Nonetheless, for the Europe of fifteen or the Eurozone, GDP growth in volume terms will not exceed 2% in 2004. The world economy will be driven by the USA (+4.4%), China (+ 8%) and other emerging economies or economies in transition.

The Luxembourg economy

Under these conditions, the Luxembourg economy should gradually emerge from the phase of sluggish growth, achieving a rate just above that forecast by STATEC in autumn 2003. This slightly more optimistic view is rooted firstly in an upward revision of the estimate of growth for the years 2001-2003, of approximately 0.5% per year, according to the national accounts published by STATEC in early May. Secondly, the monthly and quarterly figures for the second half of 2003 and the beginning of 2004 confirm this recovery sentiment, albeit to varying degrees.

The brighter outlook is also justified by a favourable international climate, a banking sector on the road to recovery and a public sector that is less constrained by the limits laid down by the Stability and Growth Pact. Indeed:

- The financial sector picked up in 2003 with better results, thanks mainly to brokerage margins, whereas commissions tended to stagnate; 2004 should be better than 2003, in view of the data for the first half of the year;

- the public deficit for 2003 has been revised from –0.6% of GDP to –0.1%; this means that the government has slightly more room for manoeuvre as far as public finances are concerned.

STATEC therefore expects GDP growth of 2.5% in 2004 and 3.5% in 2005. These figures are close to those put forward by the international organisations for Luxembourg. One cannot over-emphasise that these forecasts are contingent upon many factors and move within a fairly wide confidence range. The balance of probabilities has recently moved in favour of stronger growth, but uncertainties remain as to the durability of world growth and the recovery in Europe.

Employment went through a period of stagnation in 2003, whilst working hours were fairly sharply reduced. STATEC expects a slight slowdown of employment in 2004, and this has been noticeable since the start of the year: in terms of the number of people in jobs, domestic employment should increase by 1.6% in 2004 and 2005 (after +2% in 2003). A cyclical increase in the volume of work could result initially from an increase in working hours. Working hours generally behave in a pro-cyclical fashion. Indeed, it is likely that the more exposed sectors, such as manufacturing and banks, will take on hardly any new staff in the initial phase of the recovery, particularly with the modest rates of growth that are predicted. Furthermore, many of the more protected sectors, such as construction, but also trading, hotel and catering and personal services, will continue to adapt gradually to the less vigorous domestic economy. The likely future slowing of government spending, which had not yet made itself felt in 2003, will contribute to this process.

With employment on the slow burner, there is little prospect of relieving the burden of unemployment. In particular, there will be too much competition from the Grande Région. In this respect, though, a certain re-balancing also seems to be emerging. Net migration continues to fall, reaching only about 2000 people in 2003, about half the level seen during the 1990s. In time, the rise in unemployment could affect the rate of activity and, as in the past, discourage certain sections of the population from presenting themselves on the labour market. However, this mechanism has not gone into effect as yet, which partly explains the high increase in unemployment. STATEC therefore predicts an unemployment rate of 4.3% in 2004 (annual mean, after 3.8% in 2003) and 4.5% in 2005.

The rise in unemployment and the under-utilisation of productive capacities will help contain wage and price increases. Certainly, wage growth has already fallen significantly short of projections. In 2003, this is explained in particular by the decline in the financial sector, but there will also be repercussions in other sectors. STATEC is therefore lowering its forecasts of average wage cost growth to 1.9% in 2004 and 2.5% in 2005. The acceleration in 2005 is due in particular to the next wage indexation adjustment, expected at the end of 2004.

As regards retail prices, the effect of the wage component is offset by the more direct impact of oil prices and exchange rates. Therefore the slowing of inflation is likely to be gradual and eventually will make itself felt only in terms of the slowdown of wage inflation. STATEC expects retail prices to rise by just under 2% in 2004 and 2005. The next indexation adjustments will take place towards the end of the fourth quarter of 2004 and at the beginning of 2006. A risk scenario involving an oil price of USD 40 over the remainder of 2004 and an unchanged euro/dollar exchange rate would mean an average inflation rate of 2.3% in 2004 (instead of 2%) and would bring forward the indexation adjustment by 2 months.

The depression of the labour market will ultimately slow down the rise in the purchasing power of wages (after deduction of direct and indirect taxes). In fact, for the years 2003-2005, the "real" increase in wages, obtained by subtracting the rise in consumer prices from the nominal wage cost, is 0.7% p.a. This rise in purchasing power is lower than the long-term average over the years 1985-2003 (which was 1.7%).

Overview of the Luxembourg economy, 1985-2005

	1985 - 2003	2003	2004	2005
				mio EUR
GDP at current prices	...	23 476	24 760	26 344
	Annual variations in % (unless stated otherwise)			
GDP (volume)	5.4	2.1	2.5	3.5
Total domestic employment[1]	3.4	2.1	1.6	1.6
Inflation (implicit deflator of private consumption)[1]	2.3	1.9	1.9	1.6
Average wage cost[1]	4.0	1.9	1.9	2.5
Unemployment rate (registered unemployment, in % of active pop.)[2]	2.2	3.8	4.3	4.5

[1] Defined according to the methodology of the national accounts.

[2] Source: ADEM; break in series in 1997.

Source: STATEC