
PART

II

ANNUAL REPORT 2000
SUMMARY

THE ECONOMIC SITUATION IN LUXEMBOURG

Part	II	1	Inflation	38
		2	Economic Growth	39
		3	Labour market	40
		4	The financial sector in Luxembourg	41
		4.1	Monetary financial institutions	41
		4.2	Credit institutions	42
		4.3	Employment in the financial sector	42
		4.4	Investment funds	43
		5	External trade	43
		6	The balance of payments	43
		7	Public finance	43
		8	Stock market activity	44

1 Inflation

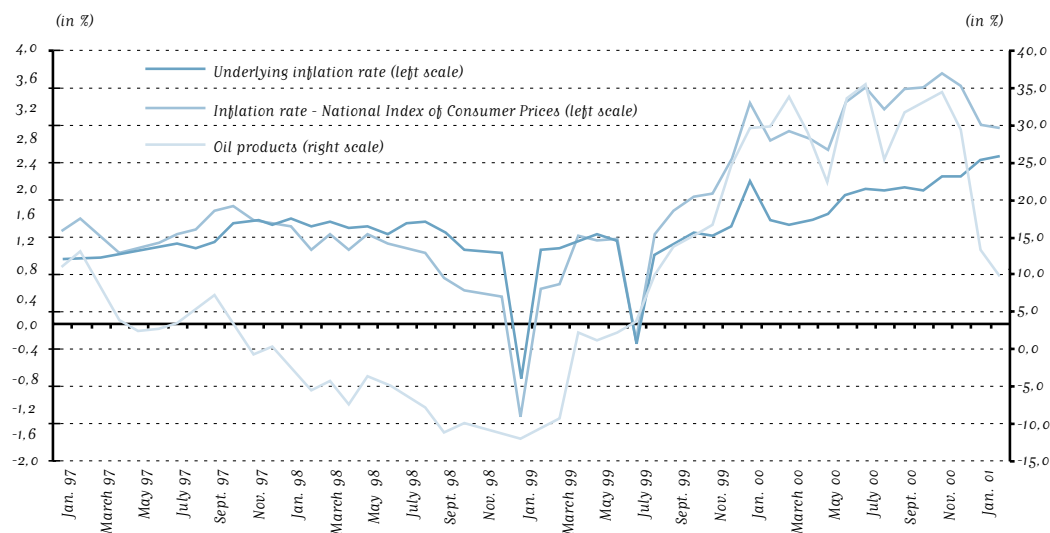
The national index of consumer prices (NICP) in Luxembourg has increased on average by 3.2% in 2000. According to the same measure, the average annual inflation rate in 1999 was 1.0%. This acceleration of inflation can mainly be attributed to international factors: the rise in the price of petroleum products over most of 2000 and the depreciation of the euro vis-à-vis international currencies. The price of petroleum products increased by 30.5% on average during the year 2000.

However, the two factors mentioned above do not entirely explain the inflation development in 2000. In fact, a similar acceleration characterised the underlying inflation rate, which tracks economic processes more closely by excluding goods whose prices are more volatile.

The increase in inflation since 1999 has been greater in Luxembourg than in other countries in the euro zone. In the past, Luxembourg's inflation generally tended to be below the euro zone average. However, since the second quarter of 1999 Luxembourg's inflation rate has been above the average euro zone inflation rate. As measured by the harmonised index of consumer prices (HICP) used for international comparisons, Luxembourg's inflation was on average 2.3% in 2000, 1.5% above that of the euro zone. In the year 2000, only Ireland, with a 5.3% annual average, experienced a higher inflation rate than Luxembourg*.

GRAPH 11:

INFLATION AND PETROLEUM PRICES



Source: STATEC

The year 2001 began with an increase in the statutory minimum wage in January and an automatic wage indexation on 1 April which should both accentuate the upwards pressures on prices. HICP inflation, excluding energy and unprocessed food, is expected to pass from 2.0% in 2000 to 2.6% in 2001 (it was only 1.0% in 1999). Luxembourg's HICP inflation should drop below the euro zone average during the first quarter of 2001. This reflects the greater weight of the energy component in the Luxembourg index and its higher sensitivity to oil prices. In contrast, underlying inflation will remain above that of the euro zone throughout the year 2001.

The next automatic wage indexation is expected in mid 2002. However, the exact date is difficult to forecast due to uncertainty on the international market for petroleum products. Automatic wage indexation

*See also 'L'accélération de l'inflation au Luxembourg', published by the BCL in the Bulletin 2000/1.

may occur earlier or later, depending on how favourable petrol price developments will be relative to our working hypothesis.

2 Economic Growth

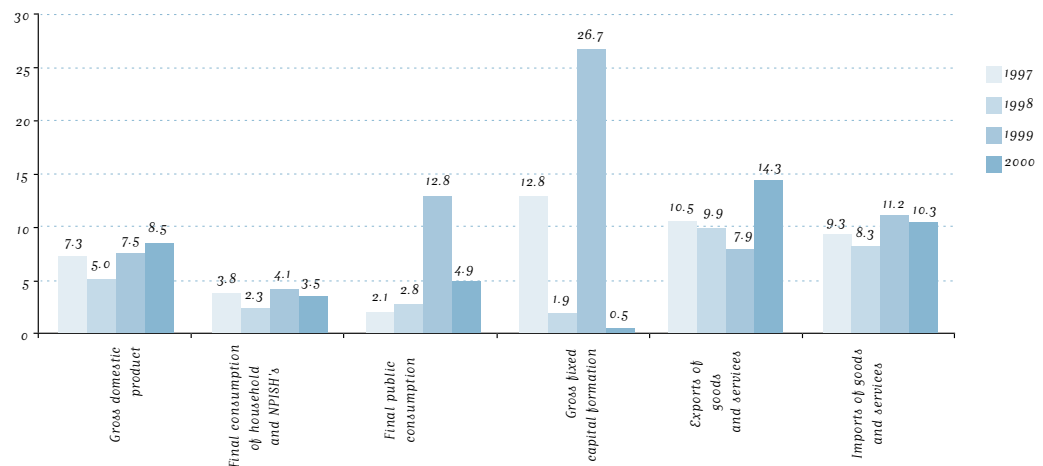
Benefiting from a favourable international climate, economic growth in Luxembourg has been exceptionally strong. Growth of real gross domestic product (GDP) was around 8.5% in 2000. This represents the fourth consecutive year of strong economic growth. In 1999, real growth was 7.5%. Cumulative GDP growth since end 1997 has been nearly 22.5%. Economic growth in the year 2001 is also expected to be strong.

Private consumption expenditure, the most important component of GDP, increased by 3.5%. This is slightly lower than in the previous year (+4.1%). For private consumption, as for the other components of domestic demand (public consumption and investment), it is important to note that it partly represents imported goods and services.

Final consumption expenditure of the public sector has increased strongly (+4.9%). The increase was particularly high in 1999 (+12.8%) due to the introduction of long-term care insurance, supplementary family support, and increases in expenditures for social insurance and pension funds. In 2000, the expenditures for public consumption increased partly through the wage agreement in the public sector. Expenditures for long-term care insurance are also likely to have contributed to this increase.

Investment expenditure has been nearly unchanged compared to the previous year. After an exceptional growth rate in 1999 (+26.7%), this still represents a high level of investment expenditures. The services sector, including banking, transport and telecommunications should once more contribute to a growth rate above the European average.

GRAPH 12: REAL GROWTH OF GDP AND ITS COMPONENTS (IN %)



Source: STATEC

Export growth has increased from 7.9% in 1999 to 14.3% in 2000, while import growth has dropped from 11.2% to 10.3%.

Economic activity in industry slowed down in the third quarter of 2000 and stabilised thereafter. Despite the observed slowdown at the end of 2000, company executives are optimistic about the year 2001.

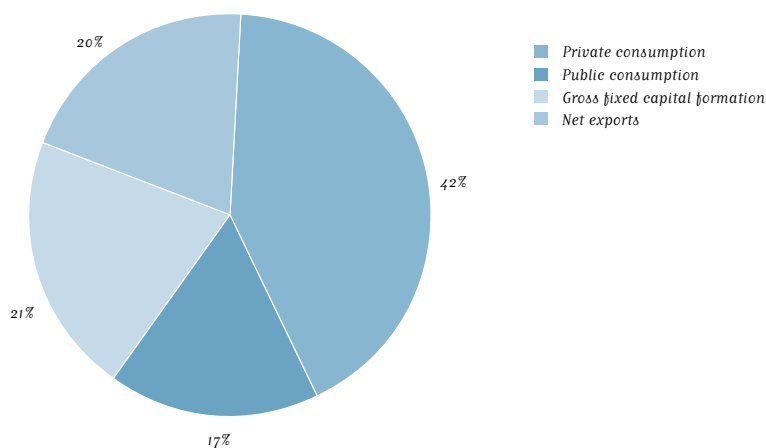
The other market services sector (including financial intermediation, real estate, renting and business

activities, transport and communications) has once again been the engine of growth in the Luxembourg economy in 2000. Its contribution to economic growth surpasses by far the contributions of industry, construction and wholesale and retail trade.

The outlook for 2001 remains generally positive in all sectors. The services sector, including banking, transport and telecommunications should once again contribute to a growth rate above the European average.

GRAPH 13:

COMPOSITION OF REAL GDP IN 2000



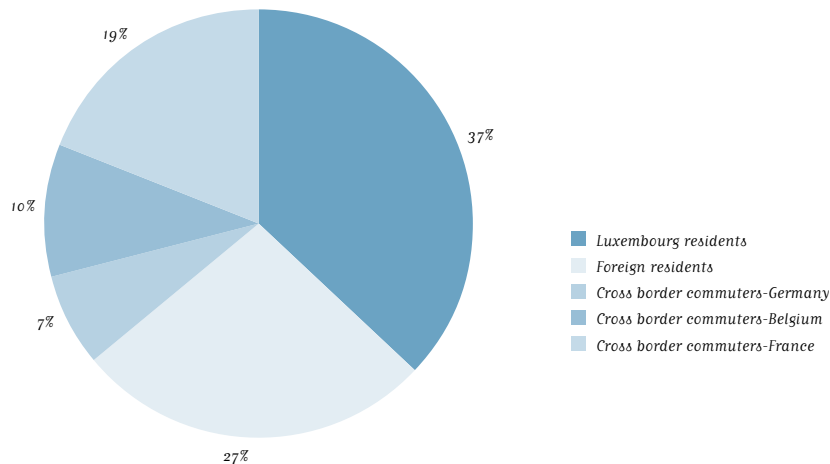
3 Labour market

The official unemployment rate is on average 2.6% in 2000, compared to 2.9% in 1999. The number of registered unemployed has declined by 387 persons on average (-7.2%).

The labour market remains very vigorous. In 2000, 14 000 new jobs were created, which marks an increase of 5.5%. This constitutes the third consecutive year of record growth, highly exceeding the average annual long-term increase, which is 3.3% for the period 1985-2000. The average level of total employment observed in 2000 represents an increase of 15.7% compared to the year 1997. During the same period, the number of employees has increased by 16.8%. While the resident population has grown by 16.3% between 1990 and 2000 (1.5% p.a.), total employment has grown by 39% (3.4% p.a.). In 2001, employment growth should once more reach a level well above the long-term average (+3.3%). It is open to question how long this growth rate can be sustained.

The inflow of non-residents has continued to account for the largest part of employment growth. Cross-border commuters represent nearly 64% of newly created jobs. This share is practically unchanged compared to last year's figure. In 2000, the share of cross-border commuters reached one third of total domestic employment (33.3% annual average). This represents an increase of 11.5% in terms of

GRAPH 14: DOMESTIC EMPLOYMENT ACCORDING TO RESIDENCE AND NATIONALITY OF EMPLOYEES



Source: IGSS (INSPECTION GÉNÉRALE DE LA SÉCURITÉ SOCIALE)

individuals. Among the cross-border commuters, 53% come from France, 28% from Belgium and 19% from Germany.

There has been a noticeable increase in the employment rate of married women. Among males, the participation rate of young people (aged 15-24) as well as older people (aged 55-65) is in decline. The participation rate of married men is higher than that of single men (84.1% versus 61.4%).

Wages and social benefits have been increased automatically by 2.5% in July 2000. The previous indexation occurred only 11 months ago.

4 The financial sector in Luxembourg

4.1 Monetary financial institutions

On 31 December 2000, the Luxembourg financial centre included 647 monetary financial institutions reporting to the Banque centrale du Luxembourg, which is a net reduction of two units compared to the number at the end of 1999.

The number of money market investment funds has increased by 6. During the year 2000, the total balance of Luxembourg's monetary financial institutions (excluding the Banque centrale du Luxembourg) has increased markedly to reach 705 920 million euro on 31 December 2000. This is an increase of 8.8% compared to the level on 31 December 1999. At the end of the year 2000, the Luxembourg monetary financial institutions accounted for 4.2% of the total balance of the monetary financial institutions in the euro zone.

4.2 Credit institutions

Increasing concentration in the banking sector marked the year 2000. The number of credit institutions declined from 210 to 202 institutions by end December 2000. Among these institutions, 139 were subject to Luxembourg law and the remaining 63 were institutions subject to foreign law.

4.2.1 Balance sheet

In the year 2000 the Luxembourg banking sector has confirmed its vigour and its importance for national economic growth. Benefiting from a favourable economic climate in Europe and the rest of the world, all activities (loans to enterprises, mortgage credits, bonds, share portfolios...) have seen spectacular increases in 2000.

The aggregate balance sheet of credit institutions has reached 647 899 million euros on 31 December 2000, which is an increase of 8.3% compared to 31 December 1999 (+10.7% average over the year). Thus the rate of growth has risen considerably compared to 1999 (+3.2% average over the year). This is primarily due to the growth in the first three-quarters of 2000, which reported an increase of 12.4%, while the increase in the last quarter was only 8.1%. The slowdown towards the end of 2000 partly reflects developments in the United States, and to a lesser extent, developments in other member states of the euro zone, and partly the decline in international financial markets, in particular in the technology sector.

Beyond the developments observed during the last quarter, the main impression is that of a banking economy in full expansion as confirmed by a double-digit growth rate on average. The rapid growth in banking output is the combined result of several positive factors: a favourable economic climate in Europe and elsewhere supporting the expansion of credit activities but also favouring market activities. These facts are consolidated by appropriate monetary policies with respect to inflationary tendencies in the U.S. and in Europe.

4.2.2 Structure and components of aggregated balance sheets

On the asset side, increased banking activity can be explained on the one hand by the increase in securities business, reflecting increased portfolio values (+49.5% in shares and 9.6% in bonds), and on the other hand by increases in loans and advances to customers and in financial leasing (+15%). On the liability side, the corresponding changes are an increase in customer accounts (+13.3%) and especially a strong increase in debt securities in issue (+17%) and in deposits from banks (+7.1%).

Bank profits reached new heights in 2000

Luxembourg banks have shown a marked increase in their level of activity, as was mentioned previously. This positive development translates into a new peak in profits. The expansion of market operations, funds business, and the dynamism of international activity sustain the increase in banks' profitability, in particular in private banking.

Moderate increases in operating charges bolster banks' profits

On the whole, overhead costs (personnel, administrative costs and depreciation of tangible assets) increased by 15.8%, which represents more than in 1999 (+4.2%). Staff costs increased by nearly 13%, which is less than other operating costs (+20.9%). Staff costs represent 48.6% of overhead costs (against 49.8% in 1999). The share of depreciation in overhead costs declined from 9.6% in 1999 to 9% in 2000. Overall, the moderate increase of operating costs relative to earnings growth allows earnings before provisions to reach more than 4.32 million euro, which reflects an increase of 20.2%. Due to this performance, earnings before provisions per employee has clearly improved, rising from 268 000 euro to 294 000 euro (+9.7%).

4.3 Employment in the financial sector

During the year 2000, employment in the financial sector has continued to increase rapidly. The intake by credit institutions and other financial professionals has increased by 2 554 units during the year, which represents an increase of 10.6% relative to 31 December 1999. On 31 December 2000, employment in the financial sector reached 26 539 individuals, which represents an increase of 767 individuals (+3%) relative to 30 September 2000. Using the latest data on the total employment in Luxembourg, one can state that employment in the financial sector now represents 10% of total employment in

Luxembourg. On 31 December 1999 this figure was 9.5%.

4.4 Investment funds

During 2000, the Luxembourg industry of investment funds was in good health despite considerable turbulence on international financial markets.

The favourable development in investment funds during the preceding year is not only reflected in the net worth under management, but also in terms of the number of funds. On 31 December 2000, the number of investment funds was 1 785, which is an increase of 155 relative to 31 December 1999. The number of fund compartments also increased by 1 159 entities to reach 6 996 on 31 December 2000.

The considerable increase in numbers can mainly be explained by the creation of new specialised funds; in particular, sectoral funds investing in specific branches of the economy, such as communication, information technology, biotechnology, etc. In any case, the introduction of the euro has also contributed to the development of new funds whose investment policy is principally targeted towards monetary currencies, which at present do not form part of the Eurosystem, such as the Danish and Swedish crowns.

However, favourable growth of the investment fund sector is somewhat offset by the very slow start of international pension funds (ASSEF and SEPCAV), whose growth is still hindered by the absence of a regulatory framework.

The Luxembourg investment fund industry did not manage to repeat its exceptional performance of 1999, but it has nevertheless enjoyed a very prosperous year, which is evident from the 19.1% increase in the net value of assets. Net assets reached 874.6 billion euro.

5 External trade

Despite strong growth in exports and a dramatic reduction in Luxembourg's acquisition of large carrier aircrafts in comparison with 1999 the trade balance has only improved slightly in 2000. The structural component of imports therefore results in a continuous increase in the volume of imports absorbed by the national economy.

6 The balance of payments

The balance of payment surplus has increased by 26.5% in the last three quarters of 2000. This increase results almost exclusively from international trade in services and particularly from the performance of the financial sector, while the deficit in goods trade and in labour income flows have diminished over this period.

7 Public finance

Current government budget policy is based on the belief that balanced public finances will allow economic policy to adapt to future business cycle evolutions. With this aim, the government coalition agreement was committed to the following:

In order to keep public debt at a very low level and raise budget reserves and assets in investment funds, the Government is committed to maintain budgetary discipline. In particular, public expenditure growth will be closely monitored to keep it within the limits of economic growth in the medium-term.

In the past, the government tended to underestimate economic growth and thus also budgetary income and expenditures during the budget process. The 2001 budget however is based on an economic growth rate, which is more in line with international institutions' forecasts for the Luxembourg economy. As a result, the growth rates of different categories of income and expenditures are higher than in the year 2000 budget.

The budget has continued to grow over the year 2000. The tax cuts for households foreseen for 2002 in the coalition agreement came into force on 1 January 2001 and will be implemented in two steps.

The ratio of ordinary receipts of central government to GDP tends to decline in 2000. However, shared Union Economique Belgo-Luxembourgeoise revenues and the additional income from VAT will increa-

se this ratio further.

The increase in total expenditures by the central government is at or below that of GDP at current prices. However, the exceptional growth in GDP over the last few years means that an economic slowdown could rapidly lead to an increase in the share of total expenditures in GDP.

Moreover, for a small open economy the risk remains that an external shock leading to a slowdown will severely affect public receipts while expenditures, which are more structural in nature, cannot easily be reduced.

8 Stock market activity

The LuxX index closed at 1388 points at the end of the year 2000. Its value is practically unchanged compared to the end of 1999 (-0.7%). As a comparison, over the year 1999 the LuxX index gained 40%. In effect, the LuxX index could not avoid the drop in the main stock markets from the second quarter in 2000. Comparing the performances of international stock market indices, the LuxX index is among the better performers, behind Dublin and Milan.

Abbreviations

BCL	Banque centrale du Luxembourg
CCBM	Correspondent central banking model
CPI	Consumer Price Index
CSSF	Commission de surveillance du secteur financier
ECB	European Central Bank
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
EU	European Union
EUR	euro
GDP	Gross domestic product
IBLC	Institut belgo-luxembourgeois du change
IMF	International Monetary Fund
IML	Institut Monétaire Luxembourgeois
LIPS-Gross	Luxembourg Interbank Payment System - Gross Settlement System
LIPS-Net	Luxembourg Interbank Payment System – Net Settlement System
LUF	Luxembourg franc
MFI	Monetary Financial Institution
NCB(s)	National central bank(s)
OECD	Organisation for Economic Cooperation and Development
RTGS system	Real-Time Gross Settlement system
TARGET system	Trans-European Automated Real-time Gross settlement Express Transfer system
UCI	Undertaking for Collective Investments
UEBL	Union économique belgo-luxembourgeoise