



I

ANNUAL REPORT 2002



ECONOMIC AND FINANCIAL SITUATION

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I

1 ECONOMIC AND FINANCIAL SITUATION

1.1 Economic situation at the international level

1.1.1 Short term interest rates

After one year of unchanged rates, the ECB decided on 5 December 2002 to reduce the minimum bid rate on the main refinancing operations of the Eurosystem by 50 basis points. This decision was followed by another rate cut of 25 basis points to 2.50% on 6 March 2003. Interest rates on the marginal lending facility and the deposit facility were also reduced by 25 basis points, to 3.50% and 1.50% respectively.

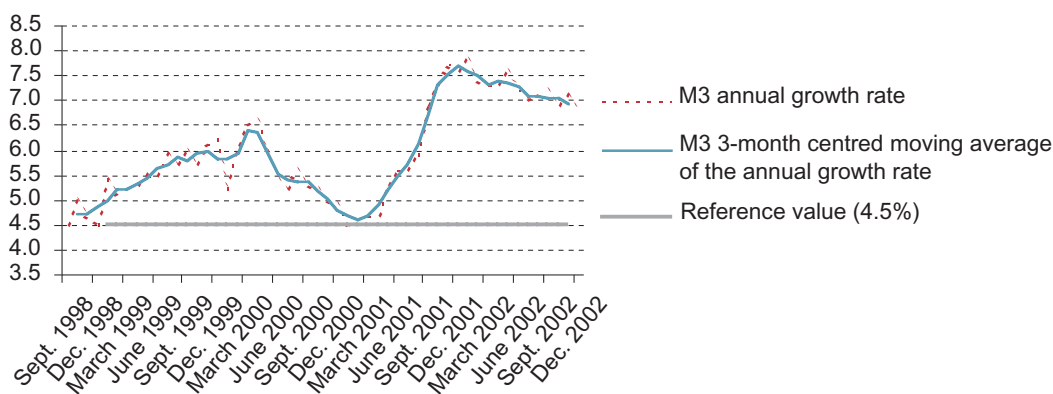
TABLE 1 INTEREST RATE DECISIONS OF THE EUROSISTEM

	Marginal lending rate		Main refinancing operations		Deposit rate	
	Level	Change	Level	Change	Level	Change
10/05/2001	3.50%	-0.25	4.50%	-0.25	5.50%	-0.25
30/08/2001	3.25%	-0.25	4.25%	-0.25	5.25%	-0.25
17/09/2001	2.75%	-0.50	3.75%	-0.50	4.75%	-0.50
08/11/2001	2.25%	-0.50	3.25%	-0.50	4.25%	-0.50
05/12/2002	1.75%	-0.50	2.75%	-0.50	3.75%	-0.50
06/03/2003	1.50%	-0.25	2.50%	-0.25	3.50%	-0.25

Source : BCE

With regard to the analysis under the first pillar, the annual growth rate of M3 remained high over the whole year. Although the rhythm of M3 growth slowed somewhat during the last months of the year, it still remains far above its reference value. Indeed, the three-month average of the annual growth rate of M3 was 6.9% from October to December 2002. This strong growth has been favoured by the preference for liquidity in an environment of financial, economic and geopolitical uncertainty, as well as by low interest rates.

GRAPH 1 EURO AREA M3 GROWTH (IN %)



Source : ECB

Turning to the analysis under the second pillar, data indicate that economic activity remained sluggish and expectations for economic growth in the euro area have been revised downwards. The outlook is particularly uncertain due to developments in financial markets, geopolitical tensions and oil price developments.

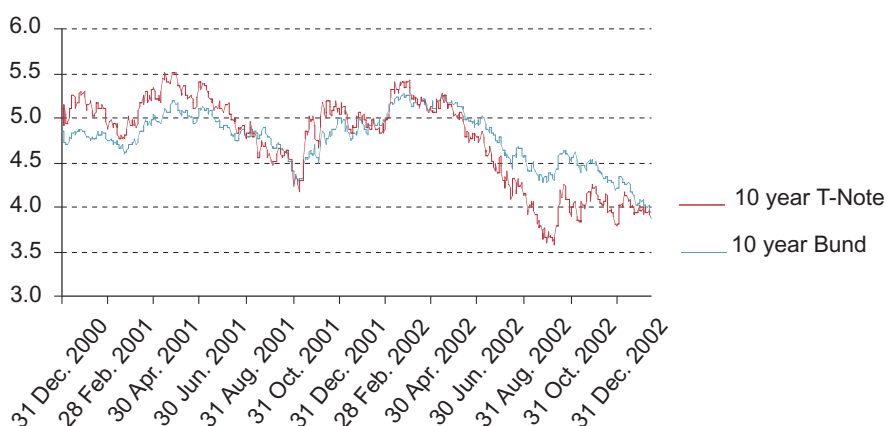
Concerning price developments, annual HICP inflation remained above 2% during most of the year. The main factors behind this were base effects related to food and to oil prices.

1.1.2 Long-term interest rates

Long-term interest rates, as measured by the 10-year T-Note and the 10-year Bund, remained broadly unchanged during the first months of 2002. In March, rates rose on more optimistic sentiment regarding the future economic outlook. New tensions, however, emerged as a result of uncertainties regarding accounting standards and the reliability of US company results.

Long-term interest rates have declined continuously since spring as investors revised downwards their expectations regarding general economic activity. Pessimism regarding economic growth increased at the end of the year with the intensification of the geopolitical tensions in the Middle East.

GRAPH 2 LONG-TERM GOVERNMENT BOND YIELDS



Source : Bloomberg

1.1.3 Stock markets

European and American stock markets declined for the third year in a row: -23% in 2002 for the S&P500 (after declining by 13% in 2001 and by 8% in 2000) and -35% for the European markets according to the Dow Jones Eurostoxx Broad Index (after a decline of 21% in 2001 and 6% in 2000).

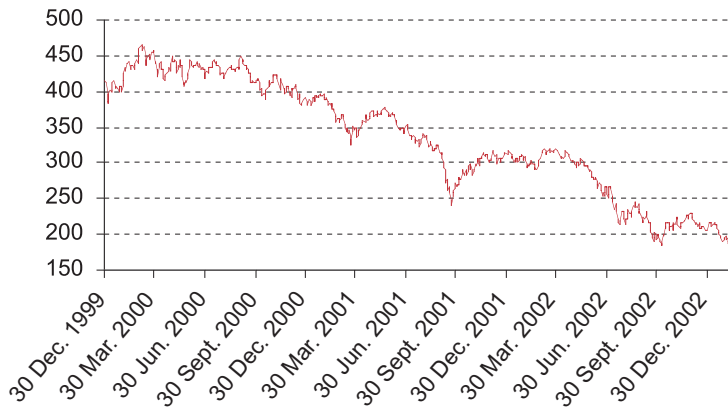
Stock prices declined continuously since the second quarter of 2002. This general pessimism reflected uncertainties concerning accounting standards and the reliability of company results, the publication of micro and macroeconomic data below expectations, geopolitical tensions in the Middle East and uncertainties regarding oil prices.

GRAPH 3 S&P500



Source : Bloomberg

GRAPH 4 EUROSTOXX BROAD



Source : Bloomberg

1.1.4 Exchange rates

The year 2002 was the first year the euro appreciated against the dollar. The euro rose by 16 cents i.e. 18% between the end of 2001 and the end of 2002.

During the first months of 2002, the euro fluctuated in a narrow band below 90 cents. Subsequently, the dollar weakened in a context of uncertainties regarding the results of US companies, a high US commercial deficit and doubts regarding perspectives for potential economic growth. The pressure on the dollar intensified with the continuous decline in stock markets. The dollar weakened further in autumn, with the decline in consumer confidence and the rise in geopolitical tensions.

During the first months of 2003, the weakening of the dollar was driven by the looming conflict in the Middle East.

GRAPH 5 USD/EUR



Source : Bloomberg

1.1.5 Price and cost evolution

1.1.5.1 Consumer prices

On average, the Harmonised Index of Consumer Prices (HICP) of the euro area increased by 2.2% in 2002, 0.2% less than in 2001. This decline reflected a more favourable outcome for the more volatile components of the HICP, which are unprocessed food and energy. In contrast, the average growth rate of the HICP excluding unprocessed food and energy increased from 2% in 2001 to 2.5% in 2002, suggesting an increase in internal inflationary pressures.

TABLE 2 DEVELOPMENTS IN THE HICP AND ITS COMPONENTS IN THE EURO AREA

(annual percentage changes, unless otherwise indicated)

	1999	2000	2001	2002	2001	2001	2001	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2002	2003
					Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.
Overall HICP	1.1	2.1	2.4	2.2	2.4	2.2	2.0	2.6	2.5	2.5	2.3	2.0	1.8	2.0	2.1	2.1	2.2	2.3	2.3	2.2
of which																				
Goods	0.9	2.7	2.5	1.7	2.0	1.5	1.6	2.4	2.1	2.0	1.9	1.2	1.0	1.1	1.3	1.4	1.7	1.8	1.9	1.6
Food	0.6	1.4	4.5	3.1	5.0	4.5	4.5	5.6	4.8	4.2	3.6	2.7	2.3	2.2	2.4	2.4	2.3	2.4	2.2	1.4
- Unprocessed food	0.0	1.8	7.0	3.1	7.5	6.2	6.2	8.3	7.1	5.5	4.2	2.0	1.2	0.9	1.4	1.8	1.6	1.9	1.4	-0.6
- Processed food	0.9	1.2	2.8	3.1	3.4	3.4	3.4	3.8	3.4	3.4	3.3	3.2	3.1	3.0	3.0	2.9	2.7	2.6	2.7	2.8
Industrial goods	1.0	3.1	1.2	0.9	0.4	0.0	0.1	0.8	0.7	0.9	1.1	0.5	0.3	0.6	0.8	0.9	1.5	1.5	1.7	1.8
- Non-energy industrial goods	0.7	0.5	0.9	1.4	1.4	1.5	1.5	1.6	1.8	1.6	1.6	1.5	1.5	1.3	1.2	1.3	1.2	1.2	1.2	0.6
- Energy	2.4	13.1	2.5	-0.6	-2.9	-5.2	-4.8	-1.9	-2.9	-1.6	-0.6	-2.8	-3.6	-1.6	-0.4	-0.2	2.5	2.3	3.8	6.0
Services	1.5	1.5	2.7	3.1	3.1	3.2	2.8	3.0	3.1	3.2	2.9	3.2	3.2	3.2	3.3	3.2	3.2	3.1	3.0	2.8
HICP excluding unprocessed food and energy	1.1	1.1	2.0	2.5	2.5	2.6	2.4	2.6	2.6	2.6	2.5	2.6	2.5	2.5	2.5	2.4	2.4	2.3	2.2	2.0

Source : EUROSTAT

Developments in the overall index were erratic, reflecting the short-term movements of the more volatile items. Indeed, global consumer price inflation decreased until June, reaching 1.8%, when it changed to an upward trend, climbing to 2.3% in December. Unprocessed food prices were the main contributors to the decline of the overall inflation in the first half of 2002 as the effects of unfavourable weather conditions dissipated, as did the upward pressures on meat prices stemming from various animal diseases. Energy prices also contributed somewhat to the decline in the consumer price inflation in the first half of 2003. However, the downward impact of the energy prices was reversed in the second half of the year, reflecting both unfavourable base effects and upward pressures on oil prices.

1.1.6 Output, demand and labour market developments

Economic growth

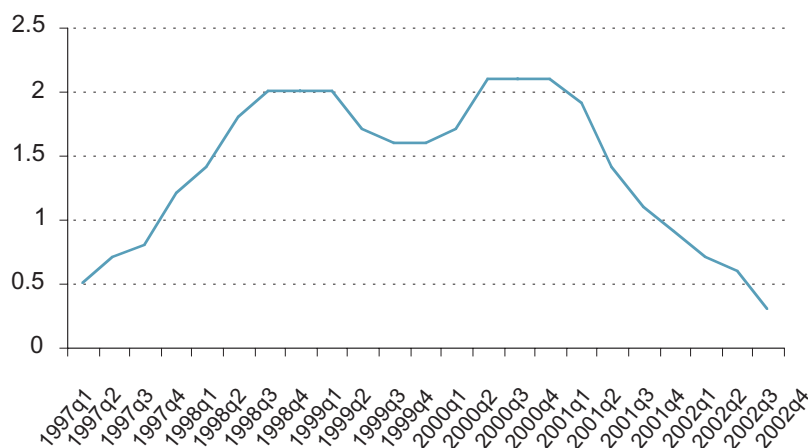
Available information indicates that economic activity remained sluggish during the first three quarters of 2002. Real GDP is estimated to have increased by 0.3% quarter-on-quarter in the third quarter of 2002, following growth of 0.4% in each of the two first quarters. This corresponds to an annual growth of only 0.9% compared with 1.3% in 2001. The lower GDP growth in the third quarter of 2002 mainly reflected a smaller contribution of net exports, as the strong increase in imports neutralised export growth. Consumption growth remained relatively robust, while investment remained weak.

Labour market

Employment growth was affected by sluggish economic activity, decelerating during the first three quarters (respectively from 0.7% and 0.5% to 0.3% according to available information). This evolution partly reflected the usual lags in cyclical developments in employment compared with economic growth. The unemployment rate increased gradually in 2002 to eventually reach 8.3% on average (8.0% in 2001).

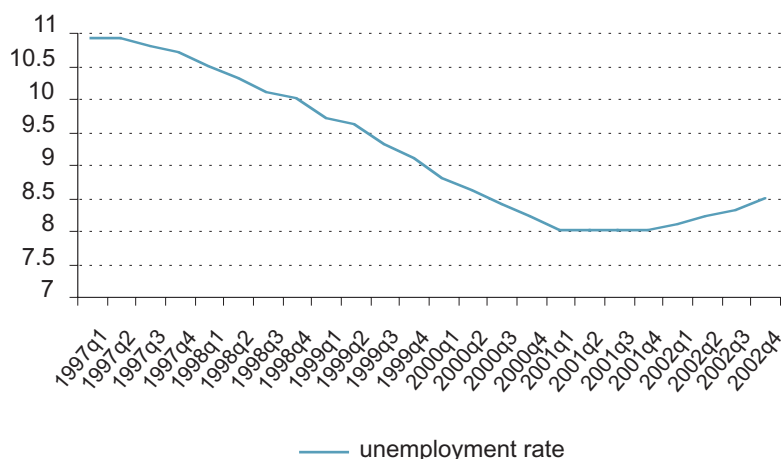


GRAPH 6 EMPLOYMENT (QUARTERLY GROWTH RATES)



Source : Eurostat

GRAPH 7 UNEMPLOYMENT RATE (ANNUAL AVERAGE; AS PERCENTAGE OF THE LABOUR FORCE)



Source : Eurostat

1.1.7 External trade

The external trade surplus reached 95.2 billion euros in the first eleven months of 2002 compared with a surplus of 40.7 billion euros in the same period of 2001. This improvement resulted from a 5% decline of imports and a small increase of exports. Main developments were a rise in trade in chemical products and a decrease in trade in machines and transport vehicles. Net external trade improved with all partners except Switzerland and Latin America.

1.1.8 Balance of payments

1.1.8.1 Current account

In the first eleven months of 2002, the current account reported a surplus of 53.8 billion euros, while the deficit was 16 billion euros in the same period of 2001. This progress mainly results from an improvement of the surplus in goods and net services. This reflected the appreciation of the euro and the weakness of internal demand.

1.1.8.2 Financial account

Net direct investment outflows reached 30.7 billion euros in the first eleven months of 2002, compared

with net outflows of 102.3 billion euros in the same period of the previous year. This development is the result of a decrease of direct investments in equity capital abroad and in the euro area, combined with a substantial decline of net outflows in inter-company loans abroad and a small increase of net inflows in inter-company loans in the euro area.

Net portfolio investment inflows reached 64.4 billion euros in the first eleven months of 2002 compared with 54 billion euros for the same period of 2001. There was, however, a shift in the composition of euro area portfolio investment. Investors preferred investing in debt instruments, which are less risky than equities, because of economic and geopolitical uncertainties.

1.2 Economic situation in Luxembourg

1.2.1 Prices and costs

1.2.1.1 Consumer prices

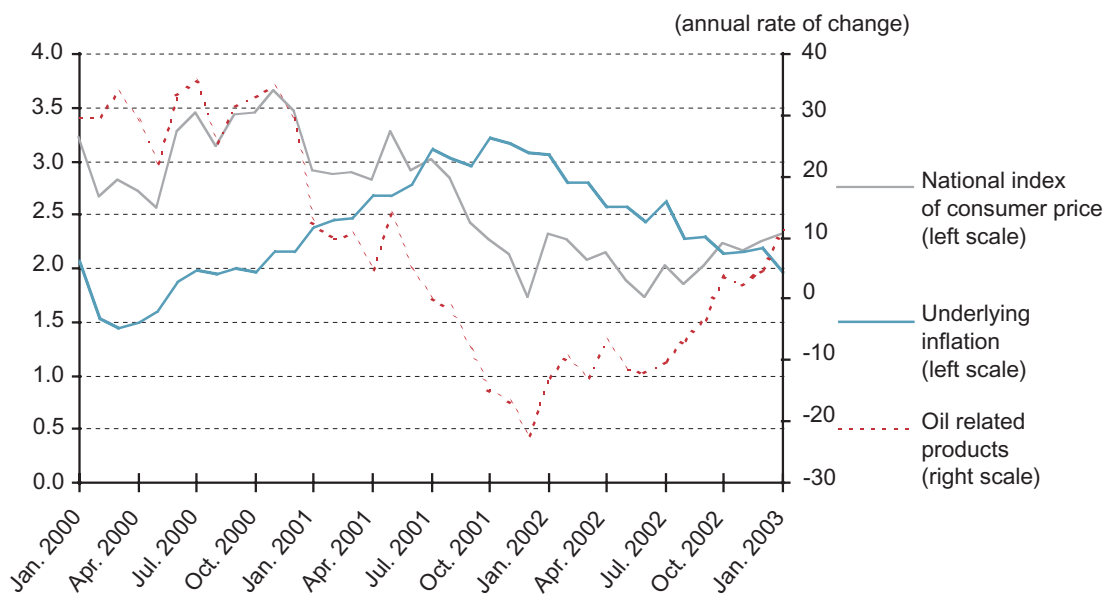
Luxembourg's National Index of Consumer Prices (NICP) increased on average by 2.1% in 2002, after 2.7% in 2001. The annual NICP growth rate decreased over the first half of the year to reach 1.7% in June. The NICP trend then reversed in the course of the second semester to reach a 2.2% yearly growth rate in December.

The decline in global inflation in the course of the first half of 2002 is mainly explained by a negative contribution from oil products. This sub-index, however, increased in the second half of 2002.

Underlying inflation, which tracks economic processes more closely by excluding goods, which have more volatile prices, decreased throughout 2002. On this measure, the annual percentage change in prices declined from 3.1% in January to 2.2% in December. The relative stickiness of this sub-index, which does not reflect the subdued economic conditions, is explained by the developments in the prices of services. Indeed, the limited decline in the year-on-year rate of change of services prices is partly due to the wage indexation of June 2002 and the impact of the introduction of euro coins and banknotes in the beginning of the year. Furthermore, increases in certain food products, like tobacco and several other unprocessed foods, have prevented a faster decline of underlying inflation.

Turning to consumer price developments in the beginning of 2003, it should be noted that the NICP year-on-year growth rate increased by 0.1% in January, from 2.2% in December. The monthly rate was -0.75% in January due to seasonal sales, which had a slightly larger impact than in 2002. Oil prices increased by 5% with respect to the previous month, with an important impact on inflation. January is also traditionally marked by increases in the prices of public utilities including retirement home services, sewage disposal and public transport.

GRAPH 8 INFLATION AND OIL RELATED PRODUCTS (ANNUAL RATE OF CHANGE)



Source : STATEC

I

Inflation projections

Since oil prices increased with respect to the previous exercise, and since the HICP excluding energy inflation is decelerating more slowly than previously expected, the outlook for headline inflation has deteriorated recently. Due to the geopolitical tensions in the Middle East, it goes without saying that the uncertainty surrounding the central scenario is currently particularly high.

Assumptions

The underlying assumptions for the HICP energy projection follow the traditional scheme, i.e. a euro/dollar exchange rate kept constant over the forecast horizon and a pattern of oil prices as observed on the futures markets. In mid-February, the quote for one euro against the dollar stood at 1.08, which corresponds to an appreciation with respect to both 2002 and the previous exercise. The price of oil fluctuated around the 30\$/bl level and the markets were anticipating a gradual fall to a level close to 25\$/bl in December 2003, overall an upward revision linked to fears of a possible war against Iraq. All in all, the euro's appreciation could not totally compensate for the increase in oil prices, implying a worsening of the outlook for the HICP energy component. Detailed assumptions are given in the following table.

TABLE 3 ASSUMPTIONS UNDERLYING THE INFLATION PROJECTIONS

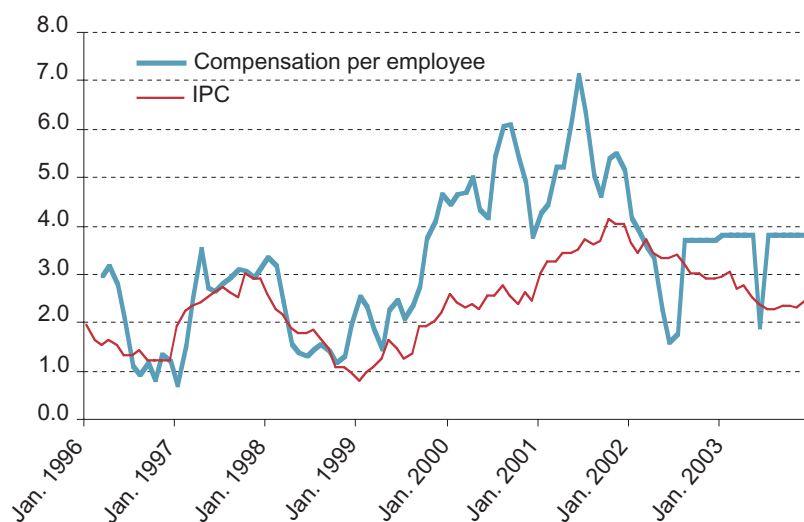
	2001	2002	2003	02-Q4	03-Q1	03-Q2	03-Q3	03-Q4
Price of oil in \$/bl	24.4	24.9	28.0	26.5	30.2	29.1	27.1	25.7
Exchange rate \$/€	0.90	0.94	1.08	1.00	1.07	1.08	1.08	1.08
Price of oil in euros (in annual percentage changes)	-11.5	-3.5	-1.0	22.5	16.6	-1.0	-8.1	-9.8

Source : BCL

HICP excluding energy is usually driven by imported inflation and wage developments. On top of that, specific measures such as indirect tax adjustments, public tariffs and administered prices may also influence inflation developments.

The increase in tobacco prices by the end of 2002 should have a non-negligible impact on consumer prices. A change in excise duties as announced in the 2002 central government budget may further enhance this upward effect. Imported inflation, however, should remain muted as a consequence of the weak economic activity in the neighbouring countries. In addition, the euro's recent appreciation against the dollar should also have a downward impact in the long run. Nevertheless, domestic inflation may decelerate only very slowly. The increase in administered prices and public tariffs at the beginning of the year should affect inflation throughout 2003 through the persistence of price changes. The size of this impact is partially reflected in the relatively high monthly change in the prices of services in January 2003. Furthermore, wage developments may not allow for a more rapid easing of inflationary pressures. The increase in the statutory minimum wage at the start of the year is likely to maintain pressure on prices. According to the projections, the timing of the next automatic wage indexation has also been advanced by a couple of months.

GRAPH 9 COMPENSATION PER EMPLOYEE AND SERVICES INFLATION (IN ANNUAL PERCENTAGE CHANGES)



Source : STATEC, BCL

Results

Inflation should slow in 2003 after a brief flare up in the first quarter of the year due to an increasing in oil prices in euros and an unfavourable base effect. NICP inflation is expected to fall below the 2% mark by mid-2003 and should remain at this level until the end of the year. Favourable developments in the second half of the year are conditional on a negative contribution from energy prices while the NICP excluding energy would only decelerate relatively slowly. This might be surprising in the context of the weak economic situation, but it actually reflects expected developments in labour costs. The automatic wage indexation would be triggered by mid-2003, somewhat earlier than previously projected, reflecting the deteriorating outlook for inflation with respect to the previous exercise.

TABLE 4 INFLATION PROJECTIONS (IN ANNUAL PERCENTAGE CHANGES)

	2001	2002	2003	2 nd half 2002	1 st half 2003	2 nd half 2003
NICP	2.7	2.1	1.9	2.1	2.3	1.5
HICP	2.4	2.1	2.1	2.4	2.7	1.6
HICP energy	-2.6	-3.7	0.8	0.3	4.2	-2.4
HICP ex energy	3.1	2.9	2.3	2.7	2.5	2.0

Source : BCL

The major risk factor for the inflation projections is of course the oil price itself, which is linked to developments in the Middle East. A peaceful outcome will probably imply a significant decrease in the price of Brent, whereas war could entail an even more unfavourable scenario.

Recently the euro appreciated against the dollar and this favourable development, if sustained, would imply decelerating inflation.

1.2.1.2 Producer prices in industry

The cyclical downturn of industrial producer prices that started in the second quarter of 2001 ended in early 2002. Prices increased again in the second and third quarters of 2002 by respectively 0.3% and 1.3%. Average prices, however, were still lower in 2002 than in 2001. The annual fall of 1.4% remains moderate when with 1996 or 1999, when prices fell by more than 4%.

TABLE 5 INDUSTRIAL PRODUCER PRICES (CHANGES WITH RESPECT TO THE PREVIOUS PERIOD)

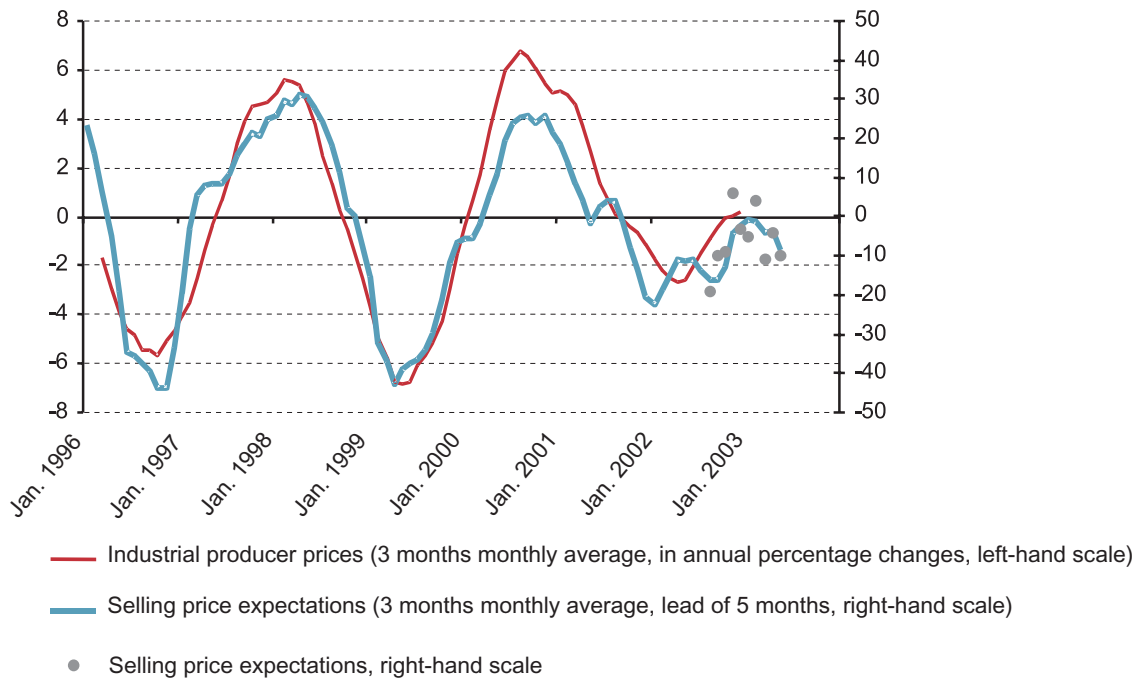
	2000	2001	2002	2001-Q4	2002-Q1	2002-Q2	2002-Q3
Total	4.8	1.1	-1.4	-0.8	-1.1	0.3	1.3
Intermediate goods	5.5	0.4	-2.4	-1.2	-1.7	0.3	1.5
Capital goods	3.3	1.8	1.2	0.3	-0.1	0.3	0.5
Consumer goods	3.2	3.6	1.3	-0.1	0.3	0.5	0.9

Source : STATEC, BCL

Industrial producer prices are usually pro-cyclical and accordingly the major reason for the decrease in 2002 was the unfavourable economic developments at both the international and the national levels. Weak demand often entails simultaneous drops in prices and production. Furthermore, the price decreases were largely concentrated in the intermediate goods industry, which is more exposed to cyclical changes than the consumer or capital goods industries.

The outlook for industrial producer prices hardly remains favourable at the beginning of 2003. Unless demand accelerates, prices are likely to stabilise, or even fall further (in annual percentage changes) according to the results of the harmonised business surveys (see graph).

GRAPH 10 INDUSTRIAL PRODUCER PRICES, PAST AND EXPECTED DEVELOPMENTS

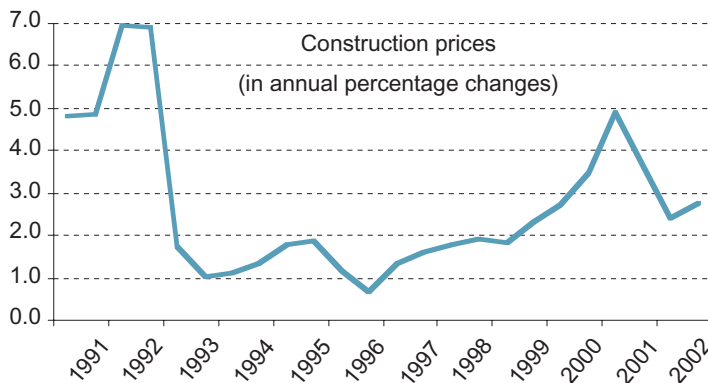


Source : EUROSTAT, BCL

1.2.1.3 Construction prices

Prices of construction services increased by 2.6% in 2002, a significant deceleration compared with the rise of 4.2% in 2001. On the one hand, in light of the high labour content of several construction services, the moderate developments are probably due to a lower impact on labour costs of the automatic wage indexation mechanism. Weak economic activity probably also entailed more moderate price increases.

GRAPH 11 CONSTRUCTION PRICES (IN ANNUAL PERCENTAGE CHANGES)



Source : STATEC, BCL

1.2.2 Sector-based activity

Industry

Industrial production in Luxembourg fell by a seasonally adjusted 1.7% in the first quarter, only to rebound by 5.2% in the second quarter and to relapse by 2.6% in the third quarter. This erratic quarterly profile resulted in unchanged production on average in 2002 when compared with 2001. All in all, Luxembourg's industry outpaced its counterparts in the euro area and, taking into account the geopolitical situation and oil price developments, the outcome was probably above expectations. Indeed, the deceleration remains largely concentrated in the steel industry, a sector much more exposed to cyclical changes, whereas the remainder of the industry increased its production on average by 1%.

TABLE 6 ECONOMIC INDICATORS FOR THE INDUSTRIAL SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	11m-2002	Q1-02	Q2-02	Q3-02
Number of employees	1.4	0.6	-1.6	-0.9	-1.9	-1.8
Wage cost	5.4	4.5	0.5	1.3	-0.2	-0.6
Hours worked	-0.6	-1.0	-3.3	-4.8	-2.8	-3.4
Turnover	10.5	3.4	-1.3	-7.2	-0.9	2.4
New orders	9.2	-2.2	-3.0	-11.5	-1.5	3.5
Production per working day (total industry)	5.1	3.1	0.0	-3.8	4.3	-1.0
Production per working day (total industry excluding steel industry)	5.2	3.6	1.0	-2.4	5.6	-0.7

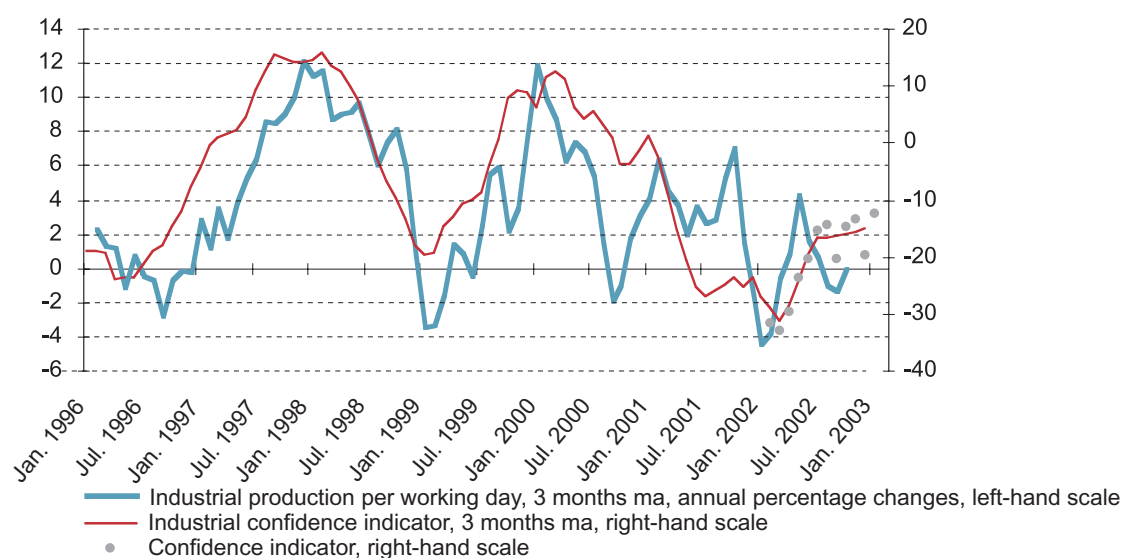
Source : STATEC

An unchanged overall level of production, combined with a fall in prices implied a decrease in turnover in 2002 with respect to 2001. Facing weak demand, companies turned to lay-offs and reductions in hours worked to contain the increase in costs.

The outlook for 2003 remains bleak. A sustained cyclical upturn, both in the US and the euro area, remains uncertain. In addition, the risk of a possible war against Iraq has been weighing on the international environment since August 2002 and has been accompanied by a sharp rise in the oil price. This period of uncertainty has stretched into 2003 without an unfolding of the events in sight.

Uncertainty has affected the results of business surveys, with a horizontal movement of the industrial confidence indicator since July 2002. Although the indicator has improved recently, a significant upturn cannot be detected. The capacity utilisation rate has declined again, as has the number of months of assured production. Insufficient demand remains the major impediment to production.

GRAPH 12 CONFIDENCE INDICATORS AND INDUSTRIAL PRODUCTION



Source: BCL calculations



Construction

The construction sector, somewhat shielded from the international business cycle, saw an acceleration of its economic activity in 2002. Production per working day increased by an annual 6.1% over the period January to November compared with an annual average change of 4.4% in 2001. The acceleration of activity was, however, largely due to the good performance of the civil engineering branch whereas activity was less buoyant in the building branch.

TABLE 7 ECONOMIC INDICATORS FOR THE CONSTRUCTION SECTOR (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	11m-2002	Q1-02	Q2-02	Q3-02
Number of employees	1.5	3.2	2.6	3.8	2.6	2.0
Wages and salaries	3.7	8.5	6.3	5.1	7.8	4.2
Hours worked	3.6	4.8	5.0	6.0	10.6	-1.3
Production per working day -Total	4.4	4.4	6.1	9.6	10.7	-3.7
Production per working day - Building	5.6	13.0	5.7	6.7	11.0	-1.5
Production per working day - Civil engineering	3.2	-4.0	6.4	13.3	10.4	-6.1

Source: STATEC

It is likely that the overall economic slowdown will also affect the construction sector in 2003. Although statistics do not yet suggest a slowdown, business surveys seem to confirm a deterioration of activity by the end of 2002. The share of companies citing a lack of demand has indeed gradually increased since October 2002 and the number of months of assured production has continuously fallen since mid-2002. Weaker employment growth may dampen demand for the sector and the number of new building permits has been falling for the first three quarters of 2002. Only loans to households for house purchases, which have risen on average by 21% in 2002, seem to offer some support for activity in the short term.

Trade and other sectors

Statistics on the turnover in the retail and wholesale trade branches have been revised downwards, painting a less favourable picture of the past. Both branches also experienced a deceleration in 2002 when compared with 2001. New car registrations posted an increase of 1.2%, the seventh consecutive annual rise.

TABLE 8 TURNOVER AND NEW CAR REGISTRATIONS (IN ANNUAL PERCENTAGE CHANGES)

	2000	2001	2002 ¹	Q4-01	Q1-02	Q2-02	Q3-02
Total trade	8.3	0.1	-1.1	-3.7	-0.9	-0.8	-1.5
Retail trade	1.2	2.9	2.4	5.1	3.8	3.7	-0.3
Trade and repair of motor vehicles	6.3	2.8	3.7	0.8	2.4	4.7	4.1
Wholesale trade	11.6	-1.6	-3.9	-8.2	-3.7	-4.3	-3.6
Hotels and restaurants	1.9	0.9	8.3	2.0	6.4	7.3	10.9
New car registrations	3.2	2.0	1.2	8.3	1.8	12.8	-3.1

Source: STATEC

Overall, future developments in the trade sector will depend, on the one hand, on the international demand for wholesale trade and on the other hand, on consumer spending, for the retail trade. The latter might be adversely affected by more restrained household spending on durable consumer goods. Indeed, the current cyclical downturn combined with the slowdown in employment growth and the general increase in uncertainty is likely to outweigh the positive impulses on private consumption stemming from the personal income tax reform and wage developments.

The statistical coverage of the other sectors of the Luxembourg economy is scarce and consequently it

¹ The data refer to the first nine months of the year, except data for new car registrations which refer to the whole year.

is more difficult to ascertain the pace of economic activity. Since both the industrial and the banking sectors are experiencing cyclical downturns, however, second-round effects on the dependent sectors are highly likely. According to official VAT statistics, turnover decreased in the first nine months of 2002 in all the other private sectors except transport services. The bleak conditions are confirmed by the chamber of commerce business survey which indicates that business conditions in 2002 were worse than in 2001. Furthermore, they confirm that the downturn was relatively more important in the services industry than in the manufacturing sector.

1.2.3 Economic activity

According to current estimates, real GDP growth in Luxembourg slowed in 2001 to 1.0% from 8.9% the year before. Preliminary forecasted figures released by STATEC indicate that real GDP growth is expected to have decelerated further in 2002 to around 0.5% (between 0.5% and 2.0%) on the back of weak international demand and of a protracted fall in stock markets.

Private consumption expenditure, the most important component of GDP, is forecasted to have decelerated from 3.6% growth in 2001 to 2.0% in 2002. Despite the reduced tax burden following the fiscal reform package, households are expected to reduce the share of income consumed in order to increase their savings as a precautionary measure.

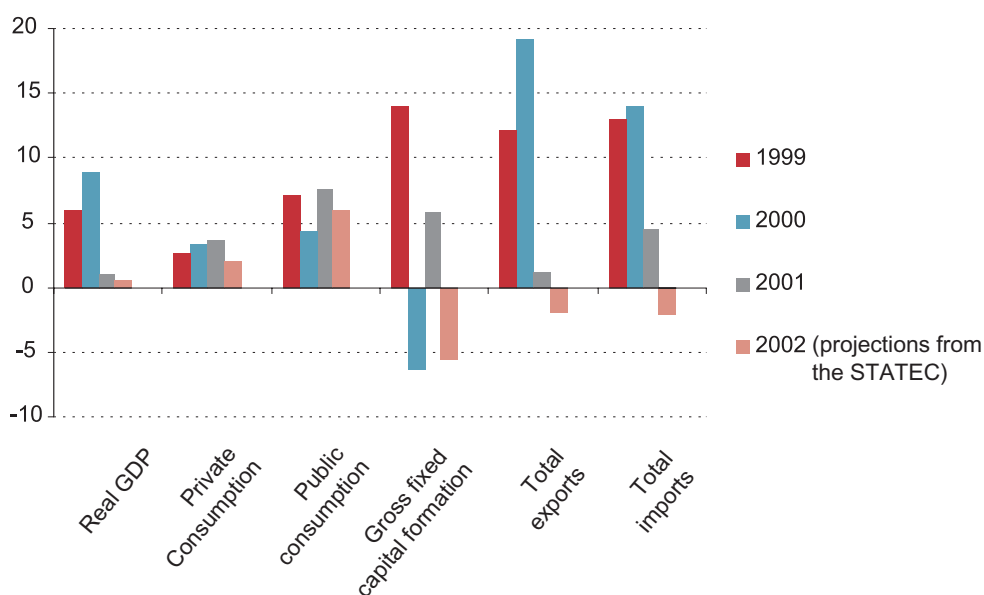
The growth of public consumption expenditure is expected to have slightly decelerated from 7.5% in 2001 to 6.0% in 2002.

The preliminary forecast concerning the gross fixed capital formation expects a strong drop in its average growth in 2002 (-5.6% in 2002 after 5.9% in 2001). This development might be attributed to the slowdown in domestic and international demand, which negatively affected investments.

As sluggishness is expected to have prevailed throughout 2002, the preliminary outlook concerning foreign trade is grim. Both real export and import growth are expected to have fallen respectively by 2.0% and 2.1% in 2002. More precisely, the preliminary forecasts released by the STATEC stress that export growth in financial services is expected to have been sharply affected by the protracted fall in stock markets.

It should be noted that STATEC might release official National Accounts figures for 2002 at the end of April 2003.

GRAPH 13 REAL GDP GROWTH AND ITS COMPONENTS (ANNUAL PERCENTAGE CHANGE)



Source: STATEC

I

Outlook for the Luxembourg economy

In the beginning of 2003, the macro-economic outlook for Luxembourg has not changed much compared with the end of 2002. It remains affected by the climate of uncertainty that prevailed since mid-2002. Geopolitical tensions associated with the risk of a war against Iraq have entailed an increase in the oil price, which is likely to weigh on economic activity. Although one might assume or hope for this period of uncertainty to end, a bet on a quick cyclical rebound, either in Luxembourg or in the major economic regions, might be erroneous.

In the euro area, the absence of major macro-economic disequilibria and the recent easing of monetary policy should pave the way for the revival of economic activity. The rebound, however, also depends to a large extent on the US economy which is still suffering from the consequences of the stock market bubble as well as over-investment in some sectors.

A more significant depreciation of the US dollar against the euro is often cited as a possible scenario as it might help to correct the US current account deficit which has persisted for several years. This scenario, however, would likely result in weaker foreign demand for the euro area, whose economic growth would then be more dependent on domestic demand.

In the wake of lower euro area growth, Luxembourg would also become accustomed to more "normal" GDP growth rates. Weak US and euro area growth would weigh on Luxembourg exports, the main driving force of the economy. Although public consumption is unlikely to falter in a low growth environment, it will not be sufficient to boost growth either. In a small open economy like Luxembourg, largely dependent on developments in neighbouring countries, it is important to avoid the emergence of domestic disequilibria which would reinforce the weak international environment. Since corporate profitability has probably deteriorated for the second consecutive year in 2002, one key issue is wage developments. A certain degree of wage moderation might indeed both help companies to remain competitive in a weak international environment and contain domestic inflationary pressures which have contributed to the unfavourable inflation gap with the neighbouring countries.

1.2.4 The financial sector

1.2.4.1 Monetary financial institutions

On 31 December 2002, the Luxembourg financial centre included 554 monetary financial institutions (MFIs), 64 less than a year earlier. The number of credit institutions decreased by 12 units and the number of money market funds by 52 units.

The aggregate balance sheet of Luxembourg's MFIs decreased by 4.3% during the year under review to reach a total of 781 344 million euros as of 31 December 2002.

1.2.4.2 Credit institutions

The concentration process continued throughout 2002, with several mergers among Luxembourg branches and subsidiaries of foreign banks. In comparison with the end of 2001, the number of banks officially registered in Luxembourg went down from 189 to 177.

1.2.4.3 Mergers and Acquisitions

The year 2002 was marked by three liquidations, the creation of 2 new credit institutions, the transformation of 2 credit institutions into other financial intermediaries (OFI) and 9 mergers or acquisitions.

Nevertheless, increasing concentration was not the only factor responsible for the fall in the number of credit institutions. Current developments in financial markets as well as poor economic growth in most developed economies may induce further concentration in the financial sector. Indeed, many international groups have concentrated their private banking activities in Luxembourg. Their Luxembourg branches and subsidiaries therefore suffer from customers' lower interest in trading and may be subject to additional restructuring efforts should the economic slowdown persist in the coming months.

1.2.4.4 Number of institutions

On 31 December 2002 Luxembourg's financial centre counted 177 credit institutions. Among these institutions, 122 were subject to Luxembourg law and the remaining 55 were institutions subject to foreign law.

The degree of internationalisation remained stable during 2002. Luxembourg's credit institutions established 22 branches in foreign countries; 14 branches are established in another EU Member State and 8 branches are established outside the EU.

1.2.4.5 Aggregate balance sheet

After several years of sustained growth within the Luxembourg banking sector, the volume of activities declined during the year 2002.

As at 31 December 2002, the aggregate balance sheet total of credit institutions reached 662 618 million euros, which represents a decrease of 8.1% compared with 31 December 2001. The decrease of the aggregate balance sheet may be explained by unfavourable economic developments in Europe and world-wide, but must also be seen in the light of the reduction of the number of the credit institutions in Luxembourg: 177 at the end of the year 2002 against 189 on 31 December, 2001.

1.2.4.6 Aggregate balance sheet structure

The structure of the aggregate balance sheet emphasises the increasing importance of interbank operations for Luxembourg banks. In this perspective, one should note that the economic slowdown in the euro area is a serious barrier to the development of Luxembourg's banking activities. In addition, the reduction of the number of credit institutions also influences the decrease of the aggregate balance sheet. Furthermore, nine mergers implied the elimination of overlapping activities. Considering that the Luxembourg financial market is characterised by strong volumes of interbank activities, any merger between two banks necessarily generates a certain reduction in activity.

Although interbank credits have decreased moderately by 20 271 million euros (-5.5%) to reach 52.2% of the aggregate balance sheet, they account for 34.7% of the aggregate balance sheet decrease. Credits granted to the non-banking private sector also decreased significantly by 11.9%. The share portfolio was reduced by 4.6% to 168 605 million at 31 December 2002. Their fraction of total assets decreased only marginally from the year-end 2001 by one tenth of a percent towards 25.4% at the end of 2002. Considering the unfavourable economic outlook, one could expect a drop of applications for credits on behalf of non-financial companies as well as Luxembourg households. In fact, Luxembourg non-financial companies' demand for credits slowed during the last quarter of 2002. The average growth rate reached almost 15% at the beginning of 2002 and in March 2002 it was only 9.5%. After a short peak in June 2002 annual growth rates went down to a level of 2.1% in September 2002 and even decelerated to 0.1% at the end of December 2002 to amount to 6 879 million euros.

New mortgage contracts for buildings in Luxembourg continued growing strongly (+14.5%) throughout the year 2002 to reach 3 131 million euros. Almost all new contracts were granted to residents (3 025 million out of 3 131 million). The demand for mortgages has accelerated significantly towards the end of 2002 to reach 893 million in the last quarter. This rise can be explained by the announcement by Luxembourg banks that as from January 2003 they will pass on to their customers a reduction in the ECB's main refinancing interest rate (0.5%) in early December 2002. Moreover, the last quarter of the year is traditionally characterised by a high level of requests for mortgage loans. Customers submit their applications for credits at this time with the aim of starting their construction project in spring. The total volume of mortgage lending for Luxembourg households has risen by 4.3% during 2002 and amounts to 6 594 million euros at 31 December 2002.

Consumer credits granted to Luxembourg households also continued to rise with an annual growth rate of 6% to reach a level of 705 million euros. These consumer credits are primarily intended to finance consumer expenditure in the short and medium term. It seems that Luxembourg households do not feel overly affected by the business slowdown at present.

On the liability side, interbank deposits still played the most important role accounting for 47.4% of the aggregate balance sheet on 31 December 2002. They diminished by 9.3% whereas debts towards



customers dropped by 7.4 %. Luxembourg banks preferred to raise finance by issuing debt securities rather than by money market instruments. Debt securities (+5.0%) reached a total of 54 900 million euros (8.3% of the aggregate balance sheet). Money market instruments were less favoured and diminished by 10.7% to reach a level of 24 631 million euros. Both instruments weakened by 0.6% which added to a total of 79 531 million euros or 12.0% of the aggregate balance sheet. The analysis of these data shows quite clearly that Luxembourg households are returning to traditional, less risky savings products. In fact, many small investors who had invested in shares have suffered important losses and reoriented their portfolios during the last six months when stock indices continued falling. This movement is evident in net redemption rates for Luxembourg mutual funds between June and December 2002.

1.2.4.7 Financial derivatives

After a year marked by a considerable increase in the volume of derivative financial instruments held by Luxembourg banks, 2002 was characterised by a sharp decrease of -15.1% (a decrease of 112 688 million euros) to reach 633 704 million euros on 31 December 2002 (excluding branches of banks originating in other EU member states).

This amount represented 114.4% of the total balance sheet of these institutions, compared with 126.7% the previous year.

Interest rate derivatives remain the main category of instruments, with a continued predominance of interest rate swaps (574 164 million euros on 31 December 2002). The volume of options contracts showed an important decrease of 132 059 million euros (-92.5%) during the year to reach 10 708 million euros on 31 December 2002.

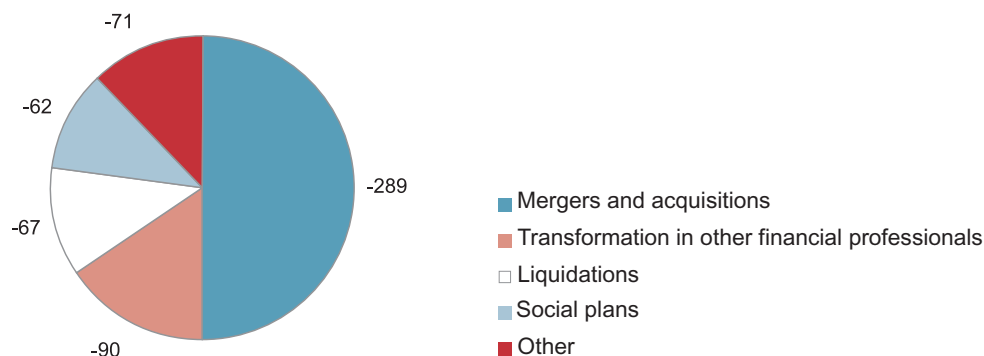
Finally, the share of contracts traded on an organised market fell to 3.3%. Thus more than 96% of transactions are in OTC contracts.

1.2.4.8 Employment in the financial sector

On 31 December 2002, the financial sector (including OFIs as well as those in credit institutions) employed 27 693 individuals, a decrease of 400 (-1.4%) from the previous year-end. The number of individuals employed in banks was 23 300 on 31 December 2002, a decrease of 579 (-2.5%) compared with the previous year-end. This accentuates the slowdown in employment growth rate observed the previous year. In 2000 the increase was 10,65% and in 2001 the increase was only 5.9%. OFIs employed 4 393 individuals against 4 199 in 2001.

As mentioned in the previous paragraph, the banking sector lost 579 jobs. A rapid analysis showed that banks having merged in 2002 diminished their staff by 289 units. The remaining losses can be easily explained by restructurings, movements from the banking sector to the OFI sector and the liquidation of 3 banks. There are also other reasons such as cost reduction, which can be interpreted as a non-employment policy, pre-pension plans, unpaid leave etc.

GRAPH 14 VARIATION OF THE EMPLOYMENT GROWTH IN THE BANKING SECTOR



In the OFI sector there was a slight increase of 194 units. This increase, however, can be explained by the transformation of two credit institutions in OFIs (90 employees). There was no significant job creation during the last two quarters of 2002.

Employment in the financial sector represents 9.7% of total employment in Luxembourg. Only 29.2% of the employees in the financial sector are Luxembourg nationals against 29.8% the year before. This proportion was 34.4% end-1999.

1.2.4.9 Investment funds

The investment fund industry in Luxembourg had a difficult year in 2002, as it did in most other European countries. The net asset value (NAV) of Luxembourg undertakings for collective investment (UCIs) experienced a series of rises and falls, mainly due to adverse financial market trends. Overall NAV, however, decreased during 2002 due to the problems faced in financial markets.

On 31 December 2002, the number of UCIs had increased by 33 and totalled 1 941 (1 908 a year earlier). The number of fund compartments continued to grow and reached 7 806 at the end of 2002.

The total NAV of Luxembourg UCIs was marked by financial market instability throughout 2002. It started strongly in 2002 with a net capital inflow of 20 050 million euros in January. This promising start, however, shifted to a net capital outflow in June, September and December 2002. On 31 December 2002, the total NAV of Luxembourg investment funds reached a high of 844 508 million euros against 928 447 million euros on 31 December 2001. This represents a decrease of 9% in comparison with net increases in previous years.

Net capital investment amounted to 57 314 million euros compared with 121 700 million euros in 2001 and 168 200 million euros in 2000.

Money market funds are part of the MFI sector and therefore are subject to the statistical reporting of the BCL. Their number remained relatively stable last year, reaching 377 units at the end of December 2002 against 426 units the year before (a reduction of 49 units). The NAV of money market funds experienced a sharp increase over the period under review, growing from 95 634 million euros on 31 December 2001 to 118 728 million euros on 31 December 2002, a rise of 23 094 million euros (+24.1%).

1.2.4.10 Profit and losses in credit institutions

Despite the ongoing weakness of global financial markets and the world-wide economic slowdown, aggregated gross revenue before taxes and provisions for Luxembourg's credit institutions remained stable at 4 575 million euros as at 31 December 2002. This represents an increase of 5.3%, compared with the level on 31 December 2001.

This appreciation in gross revenue before taxes and provisions, however, has to be considered in the context of the acquisition by Deutsche Börse of remaining shares in Cedel International held by Luxembourg's credit institutions. This generated exceptional revenues for the shareholding institutions involved.

Gross income amounted to 8 218 million euros as at 31 December 2002, increasing by 0.8 % (67 million) since 31 December 2001. Net interest income (4 151 million euros) declined by 6.9 % compared with the level on 31 December 2001. This decrease can be explained by a lower volume of activity as well as a drop in interest rates which occurred too late to have an impact in 2002.

Global expenses (staff costs and other costs) fell by 1.0% during 2002. This is mainly due to a decrease in other costs as institutions attempted to contain costs in order to maintain net results at a high level.

Provisions, mainly set up to cover risks, have increased considerably compared with 2001 growing 82.1% to reach 1 309 million euros. As a result, the aggregate net result after provisions and taxes decreased by 6.1% to reach 2 621 million euros as at 31 December 2002.

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1.2.5 The labour market

1.2.5.1 Employment

Despite the lower forecasted GDP growth in 2002, total employment (employees and self-employed) grew by 3.1% in 2002. This positive growth rate could seem high compared with the GDP growth forecast, but in fact this evolution could be partly explained by the usual lags of employment relative to changes in economic activity (total employment growth fell from 4.3% at the start of the year to 2.3% by year end). The inflow of non-residents continued to account for the largest part of employment growth. Most newly created jobs were still taken up by non-residents (65%) in 2002. Average growth in cross-border employment reached 5.8% in 2002 after 11.5% in 2001. Among cross-border commuters, 53.0% come from France, 27.5% come from Belgium, and 19.5% from Germany.

Residents' participation rate continued to increase, reaching 63.0% in 2001 (after 62.7% in 2000). This rate is still below the EU15 average (64.0%), mostly because of significantly lower participation of women (50.8% in Luxembourg compared with 54.9% in the European Union).

GRAPH 15 EMPLOYMENT DEVELOPMENTS (AVERAGE OF ANNUAL GROWTH RATE)



Source : IGSS, STATEC

1.2.5.2 Unemployment

The unemployment rate was 3.0% on average in 2002, compared with 2.6% in 2001. The number of registered unemployed increased substantially by 896 persons on average (+18.2% after -0.7% in 2001). This can be explained mostly by the cyclical downturn and is in line with the observed deceleration in employment growth.

GRAPH 16 UNEMPLOYMENT RATE (ANNUAL AVERAGE; AS PERCENTAGE OF THE LABOUR FORCE)



Source : IGSS

Preliminary figures released by STATEC suggest that average labour costs decelerated drastically during the first two quarters of 2002 and accelerated during the third quarter. This acceleration could be attributed to one major factor: nominal wages and social benefits were increased by 2.5% in June 2002 by the indexation mechanism. Nevertheless, yearly increase in average labour costs, which was high throughout 2001 (+5.5%), could have experienced a severe slowdown in 2002 because the cyclical slowdown could have had a negative impact on bonuses and constrained wage demands during the wage bargaining rounds.

1.2.6 External trade

For the first eleven months of 2002, the trade deficit reduced modestly to 2 885 millions euros, reflecting a 2.9% drop in comparison with the same period of the previous year. Exports and imports of goods recorded a drop of respectively 3.1% and 3.0% in nominal terms. Both decreases were stronger in volumes (-6.7% for exports and -3.7% for imports). The drop of nominal exports was limited to 3.1% under the effect of a strong rise (+3.8%) in export prices. As import prices increased by 0.7%, the terms of trade improved by 3.1% contributing further to the reduction in the trade deficit.

1.2.7 Balance of payments

For the first three quarters of 2002, the current account registered a surplus of 1 943 million euros compared with a surplus of 1 575 million euros during the same period of 2001. This improvement originated mostly from a substantial decrease in the goods deficit (by 29%), due to a drop in goods imports (-5%) combined with an increase in exports (1%). Regarding other items, the services surplus increased by 2% while the deficit of the income balance increased substantially (23%) due to the compensation of cross-border workers.

In the financial account, net outflows amounted to 2 717 million euros during the first three quarters of 2002. Portfolio investment, however, registered substantial net inflows of 66 312 million euros. The money received by mutual funds, and to a lesser extent the money market instruments issued by residents of Luxembourg, largely explain these inflows. The substantial portfolio net inflows have been balanced by net outflows in direct investment (22 007 million euros) and other investment (45 710 million euros). The net outflows in direct investments originated mostly from inter-company loans provided by Luxembourg residents. Other investments net outflows reflected sizeable decrease in the short-term liabilities of the Luxembourg MFIs.



1.2.8 Foreign direct investments

During the year 2000, the stock of foreign direct investments was estimated at 24 874 million euros. This figure did not include inter-company loans. The banking sector seemed to attract more investments from abroad. Investments in the banking sector represented 68% of all foreign investments. Industry attracted 14% while the insurance sector accounted for 5.3% of foreign investments.

In terms of geographical breakdown, 80% of foreign direct investments in Luxembourg came from EU residents, especially from Germany, France and Belgium. Directs investments from the United States represented 13.9% while those from Japan and Switzerland amounted respectively to 2.8% and 2.1%. Direct investment abroad was estimated at 9 160 million euros for the year 2000. Luxembourg's investments abroad were concentrated in industry.

1.2.9 Public finance

1.2.9.1 Fiscal policy stance in Luxembourg

The central government draft budget was amended by the government in November in line with a significant deceleration of economic activity. Compared with the initial budget, central government expenditure and revenue were adjusted downward by about 2% to 6%. The budget should be roughly in balance.

Although the central government budget is useful to grasp the main features of fiscal policy in Luxembourg, it does not offer a fully comprehensive view of public finance developments. In 2001, the central government represented only about one half of the total general government non-consolidated budget, which includes not only the central government but also the social security system and local government. Moreover, the official presentation of the budget does not comply with the ESA 95 accounting rules. These rules are especially important, because they require the inclusion of the so-called special and investment funds in the central government account, and because they are the reference for monitoring compliance with the requirements of the Maastricht Treaty and the Stability and Growth Pact. For these reasons, the following paragraphs focus on the ESA 95 version of the general government accounts.

TABLE 9 THE 2003 BUDGET (MILLION EUROS, UNLESS STATED OTHERWISE)

Million euros, unless stated otherwise				
	2002 Budget	Draft 2003 budget	2003 amended Budget	Nominal rate of growth ⁽¹⁾
Revenue	5,977.2	6,468.7	6,349.7	6.2%
Current revenue	5,935.2	6,424.3	6,305.3	6.2%
Capital revenue	42.0	44.4	44.4	5.7%
Expenditure	5,999.0	6,465.8	6,349.2	5.8%
Current expenditure	5,146.0	5,567.3	5,521.3	7.3%
Capital expenditure	853.0	898.6	827.8	-2.9%
Balance	-21.8	2.9	0.5	

Source : Finance Ministry

(1) Evolution between the 2002 budget and the 2003 amended budget.

1.2.9.2 General government revenue in Luxembourg

As a percentage of GDP, total general government revenue was remarkably stable over the period 1997-2001. The decrease observed in 1998 following a first downward adjustment in direct tax rates was offset by an increase of the same magnitude in 2001. This was in spite of the implementation of a generous personal tax reform in 2001, and reflected the resilience of social security contributions. In fact, social contributions depend in a direct and even proportional way on the wage bill in Luxembourg. Since the wage bill traditionally lags GDP growth, the economic slowdown in 2001 mechanically

increased the ratio of social contributions to GDP. This helped somewhat to insulate total revenue – which increased by 5% in nominal terms – from the unfavourable economic context.

TABLE 10 GENERAL GOVERNMENT REVENUE IN LUXEMBOURG (AS A PERCENTAGE OF GDP, UNLESS STATED OTHERWISE)

(as a percentage of GDP, unless stated otherwise)										
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005
	ESA 1995 data (February 2003)						Stability programme			
Current revenue	47.1	45.6	45.6	46.2	46.9	48.5	46.4	46.8	45.8	45.4
of which direct taxes	17.4	16.4	15.8	15.8	15.9	16.9	--	--	--	--
of which indirect taxes	13.6	13.5	14.4	15.0	14.3	14.3	--	--	--	--
of which social contributions	11.5	11.2	11.4	11.4	12.5	13.1	--	--	--	--
Capital revenue	0.2	0.1	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2
Total revenue	47.2	45.8	45.8	46.3	47.0	48.6	46.6	47.0	46.0	45.6
Nominal rate of growth of total revenue (%)	9.0	6.3	9.4	13.3	4.9	4.8	--	4.1	2.7	4.2

Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations

The data mentioned in the last four columns of the table have been extracted from the fourth update of the stability programme. The breakdown between current and capital revenue, however, results from BCL calculations. Furthermore, the growth rate of total revenue calculated for 2003 has been derived on the basis of total revenues reported for 2002 in the stability programme.

Social contributions exerted the same stabilising effect in 2002, although to a lesser extent. Direct revenue in 2002 has also been particularly strong in spite of an adverse context. First, a new fiscal reform was implemented in 2002. It consisted in an alleviation of tax rates for households as well as for companies. Second, the economic slowdown was even more substantial in 2002 than the previous year. The strong resilience of direct taxes in such an environment is attributable to a significant acceleration in the collection of business tax arrears, which took place especially at the end of 2002.

This reliance on the collection of tax arrears cannot be sustained for long, however, as the stock of tax arrears is decreasing. In the steady state, business tax revenue should converge to a level that is more in line with the underlying economic activity. This could give way to significant tax shortfalls in the future.

1.2.9.3 General government expenditure

Disregarding the impact of a one-off transaction related to SES Global, total general government expenditure would have increased by 10% in 2002 and would amount to 46% of GDP. According to the fourth update of the stability programme, this ratio would only slightly decrease from 2003 to 2005 and the nominal growth of general government expenditure would reach 3.9% in 2003, 3.3% in 2004 and 2.7% in 2005. These rates of growth are extremely low by past standards in Luxembourg. In fact, total general government expenditure increased by 8% a year, on average, over the period 1991-2001, and it was up by 10% in 2002. This shows that a significant slowdown in expenditure growth would be required in order to ensure compliance with the objectives set out in the stability programme.

TABLE 11 GENERAL GOVERNMENT EXPENDITURE IN LUXEMBOURG (AS A PERCENTAGE OF GDP, UNLESS STATED OTHERWISE)

(as a percentage of GDP, unless stated otherwise)										
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005
	ESA 95 data (February 2003)						Stability programme			
Social payments	21.1	19.9	20.4	19.3	20.7	23.1	--	--	--	--
Government investment	4.2	4.5	4.6	4.1	4.3	4.7	--	--	--	--
Compensations of employees	9.2	8.8	8.5	8.0	8.3	9.0	--	--	--	--
Other expenditure	9.5	9.5	8.8	8.8	7.4	9.3	--	--	--	--
Total expenditure	44.0	42.7	42.3	40.2	40.6	46.1	47.0	47.3	46.7	45.6
Nominal rate of growth of total expenditure (%)	5.9	6.5	8.3	6.4	9.4	9.7	--	3.9	3.3	2.7

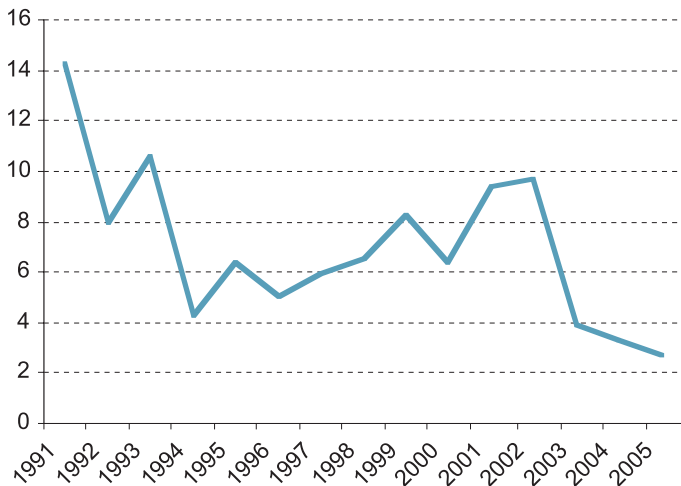
Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations



The data mentioned in the last four columns of the table have been extracted from the fourth update of the stability programme. The expenditure level recorded in 2001 has been affected by a one-off transaction related to SES Global, which decreased total expenditure by 2% of GDP in 2001. This factor explains the substantial decrease of the item "other expenditure" in 2001 and the offsetting increase recorded in 2002. Furthermore, the rate of growth of total expenditure calculated for 2003 has been derived on the basis of the total amount of expenditure reported for 2002 in the stability programme.

Such a deceleration will be difficult to implement due to the conjunction of four factors. First, public investments should increase by 31% in 2003 according to the stability programme. Second, wages in the public sector should increase by 1.6% in 2003 and 2004. Third, pension expenditure will go up significantly from 2003 to 2005, if only because of the adjustment of pensions to real wage developments. Fourth, health expenditures are likely to increase at a sustained pace due to a growing number of insured persons and the increase in costs. The implementation of structural reforms aimed at decreasing the spontaneous increase in general government expenditure is particularly desirable in such a context. This is all the more so as general government expenditure per capita is much higher in Luxembourg than in the rest of Europe.

GRAPH 17 NOMINAL RATE OF GROWTH OF GENERAL GOVERNMENT EXPENDITURE IN LUXEMBOURG (AS PERCENTAGE OF GDP)



Source : Stability programme, STATEC, BCL calculations

1.2.9.4 Net lending and net borrowing requirements

The general government surplus would record a marked decline in 2002, reaching 2.6% of GDP, compared with 6.4% the year before. This result is more favourable than forecast in the last update of the stability programme, where a deficit equal to 0.3% of GDP was envisaged for 2002. This evolution, however, is primarily the reflection of a non-structural factor, namely the aforementioned acceleration in the collection of business taxes. In addition, the central government would record a substantial deficit, close to 3% of GDP in 2004 and 2005.

TABLE 12 BUDGETARY BALANCES IN LUXEMBOURG (AS A PERCENTAGE OF GDP)

(as a percentage of GDP)											
	1997	1998	1999	2000	2001	2002	2002	2003	2004	2005	
1 Non adjusted balances: net lending (+) or borrowing (-)	ESA 1995 data (February 2003)						Stability programme				
1.1 Central government	1.9	1.4	2.1	3.0	3.1	-0.1	-2.2	-2.1	-2.8	-2.8	
1.2 Local government	0.5	0.3	0.2	0.6	0.2	0.3	-0.4	-0.6	-0.6	-0.1	
1.3 Social security	0.8	1.4	1.3	2.5	3.1	2.4	2.2	2.4	2.7	2.9	
1.4 General government (= 1.1+1.2+1.3)	3.2	3.1	3.5	6.1	6.4	2.6	-0.3	-0.3	-0.7	-0.1	
2 Cyclical component of the general government balance	-0.9	0.0	0.2	1.2	0.8	-0.2	-0.2	-0.5	-0.5	-0.4	
3 Cyclically adjusted general government balance	4.1	3.1	3.3	4.9	5.6	2.8	-0.1	0.2	-0.2	0.3	

Source : STATEC, fourth update of the Luxembourg stability programme, BCL calculations

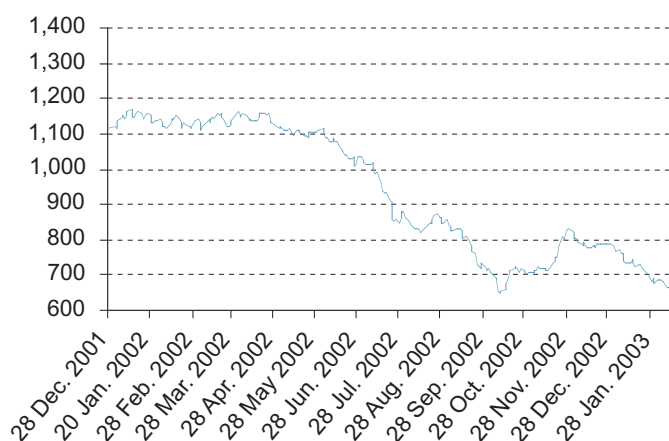
The non-adjusted balances displayed in the last four columns of the table have been extracted from the fourth update of the stability programme. The cyclically adjusted balances are equal to the non-adjusted balances minus the cyclical component. The latter has been calculated by the BCL on the basis of the Hodrick-Prescott filter.

Cyclically adjusted general government balances would be roughly in equilibrium from 2003 to 2005. The current context, however, casts a shadow of uncertainty on these results. First, they presuppose a strict monitoring of expenditure. Second, they could be affected by adverse macroeconomic developments in an unstable geopolitical context. Third, the favourable budgetary situation forecast in the stability programme critically depends on high surpluses in the social security system. These surpluses will probably decline significantly in the future. As illustrated in ad hoc projections made by the BCL, the surpluses recorded in the general pension regime are liable to decrease over the next years due to a marked slowdown in the growth of total employment and to a high spontaneous rate of expenditure growth. The same evolution would also be observed in the health system, which further highlights the need for structural reforms aimed at curbing expenditure drift.

1.2.10 The Luxembourg Stock Exchange

In a context of general turmoil in international stock markets, the LuxX index fell by 29% in 2002. A specific national factor, the phasing out of the "Rau" law which offered fiscal advantages to holders of domestic stocks, also contributed to the decline of the LuxX index.

GRAPH 18 LUXX



Source : Bloomberg



In line with the decline of the stock prices, the market capitalisation of listed companies also fell significantly in 2002. Market capitalisation of domestic companies and of foreign companies decreased respectively by 12% and 33% in 2002. This development accompanied a decline in the number of listed companies.

TABLE 13 MARKET CAPITALISATION OF LISTED COMPANIES

	Capitalisation (EUR million)			Change 2001/2002	Listings 2001/2002
	31/12/2000	31/12/2001	31/12/2002		
Domestic	36	26	23	-12%	48/48
Foreign	522	419	281	-33%	209/197
Total	559	446	304	-32%	257/245

Source : Source: Luxembourg Stock Exchange

In 2002, the Luxembourg Stock Exchange admitted an additional 7 531 securities to listing. At the end of the year, the total number of listings mounted to 26 486 securities, of which 18 883 bonds, 5 798 UCIs, 1 537 warrants and 268 stocks. The bond compartment is by far the most important (71% of total listings), followed by UCIs (22% of total listings), warrants (6% of total listings) and stocks (1% of total listings).

TABLE 14 NUMBER OF LISTED SECURITIES

	Total	Bonds	UCIs	Warrants	Stocks
1996	12,870	8,441	2,766	1,350	313
1997	14,478	9,574	3,030	1,557	317
1998	15,386	10,513	3,337	1,228	308
1999	17,051	12,021	3,658	1,060	312
2000	19,690	13,679	4,625	1,089	297
2001	23,438	16,447	5,407	1,306	278
2002	26,486	18,883	5,798	1,537	268

Source : Luxembourg Stock Exchange

The uncertainties regarding general economic activity and geopolitical issues resulted into a global decline in the volume of trading. As a matter of fact, the volume of trading declined by 28% in 2002 compared with 2001, whereas the number of trades decreased by 30% over the same period.

TABLE 15 TRADING (VOLUME IN EUR MILLION)

	2000		2001		2002		Change (2002/2001)	
	Number	Volume	Number	Volume	Number	Volume	Number	Volume
Bonds	33,561	1,000.6	27,091	1,361.8	15,341	1,223.6	-43%	-25%
Stocks	43,938	1,321.6	27,046	494.2	22,893	291.8	-15%	-41%
UCIs	16,901	496.7	7,769	292.7	5,132	231.4	-34%	-21%
Warrants	52	1.1	152	0.8	36	0.4	-76%	-51%
Total	94,452	2,819.9	62,058	2,419.5	43,402	1,747.2	-30%	-28%

Source : Luxembourg Stock Exchange

