The Governor's Message

Preserving price stability is the best contribution monetary policy can make to sustainable economic growth, job creation, prosperity and social cohesion. This has become the established consensus on monetary policy.

In an inflationary environment it becomes more difficult to disentangle changes in relative prices (which imply a change in the allocation of resources) from changes in the general price level (which should not trigger such a change), with the result that resources are misallocated, total factors productivity deteriorates, and overall macroeconomic performance worsens.

Inflation also has a negative impact on capital accumulation, and therefore on the long-term potential output of the economy, especially because of the non-indexation of the tax system. Since depreciation allowances are not indexed, this introduces a systematic distortion of business investment decisions. Ceteris paribus, higher inflation artificially increases investment in short-lived capital equipment and inventories, to the detriment of long-lived capital goods. Inflation uncertainty also causes real rates to be higher than they would be otherwise by adding an inflation risk premium to risk-free nominal interest rates, thus further discouraging capital accumulation. Empirical evidence confirms the existence of a negative relationship between inflation and output growth, with a 100 basis point permanent increase in inflation being associated with a 10 to 30 basis point decrease in trend output growth.

The Governing Council of the ECB has emphasised that maintaining price stability in the medium term is the Eurosystem's primary objective. A firm anchoring of medium and long-term inflation expectations in line with price stability is an absolute priority. The Governing Council is determined to prevent second-round effects and to ensure that risks to price stability over the medium term do not materialise.

Luxembourg's cumulated inflation differential from the beginning of phase III of EMU in 1999 to the end of 2007 stood at 2.5 percentage points vis-à-vis the euro area and 6.5 percentage points vis-à-vis Luxembourg's neighbouring countries. The Eurosystem is responsible for maintaining price stability in the euro area as a whole, without being able to take into account inflation differentials that might exist between Member States. The Eurosystem does not have any instruments which could reduce such differentials. It is therefore up to the Member States concerned to identify the reasons underlying excessive inflation differentials and to take the appropariate measures. This analysis is of particular relevance for a small open economy like Luxembourg, as any unfavourable inflation differential will in general entail a real appreciation and hence a loss of competitiveness. These differentials may be driven by increases in indirect taxes and administered prices, by higher wage increases relative to those in trading partners, by unfavourable productivity developments and by structural inefficiencies. These issues need to be addressed at the national level.

According to the latest BCL staff projections, NICP and HICP inflation should increase in 2008 to 3.6% and 4.5%, respectively. This reflects a very high contribution from energy prices. Despite the economic slowdown, this impact should be amplified by an increase in inflation excluding energy, reflecting high services price inflation and increasing food prices. NICP inflation should barely decline below 2% over the medium term. If the automatic indexation scheme is fully reinstated, robust nominal wage growth in 2010 should trigger a strong increase in services prices, boosting inflation excluding energy. This is an example of a wage-price spiral generated by the automatic wage indexation mechanism.

The BCL analysis in this Annual Report demonstrates that changes to the automatic wage indexation mechanism introduced by the "Tripartite agreement" of May 2006 probably dampened the impact of the wage-price spiral on consumer price inflation. Furthermore, BCL analysis establishes the statistical link between an automatic wage increase and the rise in consumer prices.

In mid-May, STATEC released national accounts estimate for the past three years, presenting a sharp deceleration in real GDP growth. After a series of revisions, the latest figures for GDP growth for 2005, 2006 and 2007 are 5.0%, 6.1% and 4.5%. Slowing economic growth mainly reflects weaker exports of goods and services.

On the basis of these statistics, the BCL estimates that the slowdown in early 2008 might be more pronounced in the context of worsening financial market turmoil and its negative impact on Luxembourg's financial sector results. BCL projections for 2008 as a whole foresee average annual real GDP growth in a range between 2.9% and 3.5%, which is significantly below the historical average. On the basis of the international scenario, economic growth in Luxembourg is projected to recover in 2009 to between 3.5% and 4.5%. Luxembourg's relatively high GDP growth rates by international standards have to be seen in the context of significant labour inflows meaning that productivity growth is not exceptional by international standards.

Since 1996, unit labour costs have grown faster in Luxembourg than in the surrounding countries. This increase reflects faster growth of wages per employee and slower growth of labour productivity than in the three neighbouring countries. Weak labour productivity growth could be explained by a total factor productivity contribution that has been low by international standards and even negative in the most recent years. On the other hand, the contribution of the capital-labour ratio has been higher than in neighbouring countries. This suggests that Luxembourg depends on capital accumulating much faster than employment growth. Under this configuration, Luxembourg's labour productivity seems vulnerable to a potential fall in the country's attractiveness for foreign investors.

The competitiveness indicators calculated by the BCL indicate a continuing deterioration, even when they are extended to 2010 using the results of the recent Eurosystem projection exercise. However, as noted in the BCL 2006 Annual Report, this needs to be interpreted carefully because in the past the deterioration of various price and cost competitiveness indicators was accompanied by robust export growth in Luxembourg. However, Luxembourg remains especially vulnerable to a slowdown, or even a fall, in international trade, as has been projected by the main international organisations. Luxembourg's high estimated export elasticities with respect to foreign demand suggest that such a negative development at the global level could have amplified effects in Luxembourg.

As indicated during the presentation of the BCL Financial Stability Report, the impact of the financial turmoil on the real economy and on public finances may be more negative than expected on the basis of 2007 results, especially given the wide methodological differences in evaluating falls in asset prices. Fluctuations early in 2008 represent a very important source of uncertainty for public finances. Central government may move once again into deficit in 2008. For 2009, the general government surplus should also deteriorate with respect to its position in 2008.

In this context, the BCL echoes various international institutions, and in particular the European Commission, who repeatedly stressed the urgent need for reforms to guarantee the long-term sustainability of Luxembourg's old-age pension system. In its assessment of the ninth update of Luxembourg's Stability Programme, the European Commission indicates that the estimated impact of ageing will be a spectacular increase in general government debt. This should exceed 60% of GDP shortly after 2030.

We are celebrating the tenth anniversary of the Banque centrale du Luxembourg, as it was created on the 1st June 1998.

The initial objective was to anchor the new institution within the European System of Central Banks and within the national institutional environment. This has been pursued with determination by applying a high level of professionalism.
Despite its low initial level of capital, the Bank has successfully resisted international financial shocks.

Its strategy and management have been validated by results.

At the level of the ESCB, we have been entrusted with the creation of a "Eurosystem Procurement Coordination Office". At the national level, a legislative framework for the Bank's cooperation in financial stability matters is in preparation.

This success reflects the quality and motivation of a staff that is committed to the declared values. It represents an encouragement to continue in the direction chosen and to give our best in the service of our country in the heart of our Europe.

Yves Mersch