THE GOVERNOR'S MESSAGE

On 8 June 2006 the Governing Council of the European Central Bank decided to increase the Eurosystem's key interest rates by 25 basis points, thus raising the rate for the main refinancing operations to 2.75%. The process of rate raising which started at the end of 2005 reflects the upside risks to price stability and follows the proven monetary strategy of the Eurosystem. The adjustment of the accommodative stance of monetary policy helps to keep medium and long-term inflation expectations in the euro area anchored at levels compatible with price stability. Pursuing the ECB's key objective of price stability is the best contribution that monetary policy can make over the long term to economic growth and job creation. Following this rise, interest rates are still at historically low levels and liquidity remains abundant; monetary policy continues to be accommodative.

The June 2006 Eurosystem staff macroeconomic projections are based on annual average growth of GDP in volume terms of between 1.8% and 2.4% in 2006 and between 1.3% and 2.3% in 2007. The average rise in the harmonised index of consumer prices (HICP) in the euro area should be between 2.1% and 2.5% in 2006 and between 1.6% and 2.8% in 2007.

In Luxembourg, inflation reached an average of 2.5% in 2005, compared with 2.2% the previous year, widening the gap even more with neighbouring countries. According to the latest projections of the Banque centrale du Luxembourg, inflation measured by the national index of consumer prices should remain, on average, above 2% over the projection horizon and the surge in headline inflation, from 2.5% in 2005 to 2.8% in 2006, should reflect major increases in the energy and services components.

The worsening inflation differential vis-à-vis other euro area countries is a cause of particular concern. It may be the result of the rise in indirect taxes and administered prices, of wage developments that are out of line with partner countries and of entrenched structural inefficiencies. These problems have to be addressed at the national level.

The adjustment to the indexation mechanism should slow down the increase in unit labour costs. However, according to our projections, which incorporate the effects of this adjustment, the deterioration in competitiveness should continue until the end of 2008. Indeed, the indicator based on unit labour costs in the whole economy is likely to deteriorate by a further 3.1% during the period in question.

Economic growth in Luxembourg stabilised at 4% in 2005, as opposed to 4.2% the previous year. However, activity accelerated in the course of the year, reaching a growth rate of 5.7% in the fourth quarter of 2005. The BCL revised upwards its projections for economic growth for 2006, to between 4.4% and 5.0%. The slowdown in international demand forecast for next year suggests a fall in economic growth in 2007 to between 3.4% and 4.4%. Luxembourg would thus experience a fourth consecutive year of significant economic growth.

Despite this growth, which is well above the average for the euro area, a rapid increase in central government spending has deepened the public finance deficit, which rose from 1.1% of GDP in 2004 to 1.9% of GDP in 2005. This figure confirms the validity of the BCL's calls for budgetary prudence in recent years.

When the government presented its package of reforms on 2 May 2006, it also expressed its determination to reduce the general government deficit to 1% of GDP in 2007 and to return to a balanced budget in 2009. On the same occasion, the government also announced a series of specific measures to consolidate the budget.

Unemployment (in the strict sense) rose from 3.9% to 4.2% in 2005. This rise in the rate of unemployment took place despite a 3.2% increase in overall employment in 2005 and continued in the early months of 2006, during which time several large-scale redundancies were announced.

Structural measures remain essential in order to bring about a sustainable consolidation of public finances. They should aim above all to slow down growth in general government spending, including pensions. The government's intention to reduce the increase in expenditure to 4% per year in nominal terms takes on a critical importance in this context. Moreover, structural measures could remedy unemployment while ensuring a better match between supply of and demand for labour. These measures are all the more necessary in view of the fact that the financial sector is likely to reach a maturity threshold in the future.

The pensions sector has only been affected incidentally by the measures announced by the government at the beginning of May 2006. However, outside observers, especially the European Commission, point to the sharp increase expected in pension spending in Luxembourg, which should grow by more than 7% of GDP between 2004 and 2050. This annual report includes some thinking on a move from a pay-as-you-go system to a funded system, a change which should help to improve the budget outlook for social security while protecting the latter against any slowdown in economic growth.

After a thorough analysis, the Banque centrale du Luxembourg has submitted to the government a draft amendment to its Founding Law. This draft amendment envisages giving the BCL a framework which allows for the development of its activities and those of the Eurosystem in general, and the specific need to adapt financial legislation in Luxembourg.

As part of the constant efforts the Banque centrale du Luxembourg is making to improve its efficiency and update its structures, it launched in the second quarter of 2005 an initiative called "BCL in motion". This reorganisation aims, in particular, at broadening the autonomy of decision-makers and at increasing their effectiveness. In addition, staff members' skills will be mobilised more effectively through active human resource management, and internal communications will be strengthened.

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