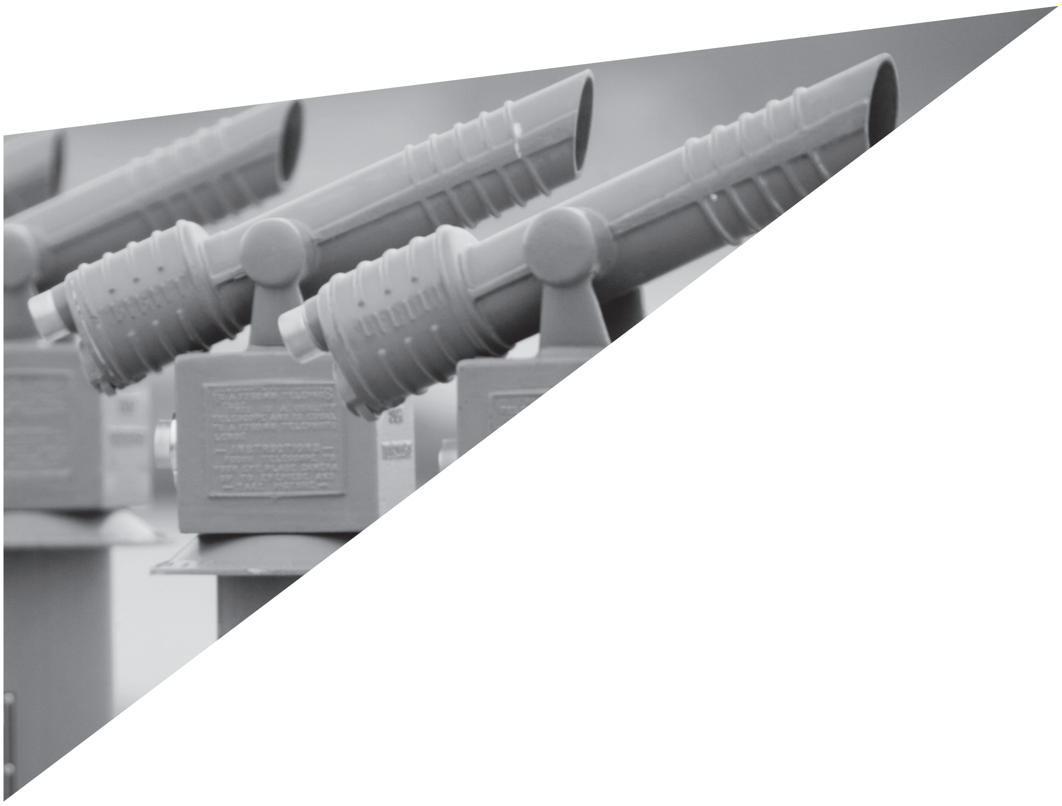
Ernst & Young Eurozone Forecast

Luxembourg

Spring 2010



Ernst & Young
Quality In Everything We Do

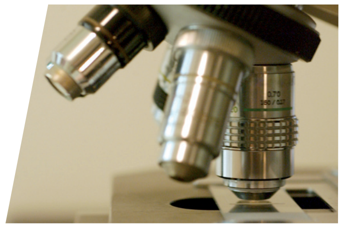
Outlook for Luxembourg

Ernst & Young Eurozone Forecast

Spring 2010

Please visit our dedicated Eurozone website for access to additional information on the Eurozone report, the 16 individual country reports and additional perspectives and interview content. The site contains the latest version of our reports, provides access to print ready files as well as an archive of previous releases.

To find out more please visit www.ey.com/eef



Highlights

Slow recovery in financial services to weigh on growth

- Luxembourg was right in the eye of the storm during the recession as financial services was seriously affected by the global banking crisis and and its steel industry suffered as a consequence of the downturn in global industrial production. Damage to the capitalization of hosted banks and funds will keep the growth of the financial sector (and the economy) well below recent trends until 2012. But we expect Luxembourg to return gradually to growth of around 3% per annum.

- We forecast growth of 1.7% this year, rising to 2.1% in 2011. In the short term, growth will be dragged down by investment which is likely to remain weak for some time, given ample spare capacity. This will partly offset the expected rebound in exports of services — although we do not see a return to the pre-crisis boom years in this sector.

- Despite slack demand and rising unemployment, inflationary pressures remain. Underlying inflation was still around 2% at the start of this year, and customary wage indexation makes labor costs difficult to reduce. This will mainly affect Luxembourg's manufacturers who struggle to remain competitive.

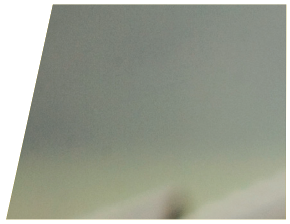
- The combination of the recession and the measures to stabilize the financial sector have turned a previously reliable fiscal surplus into a deficit that is expected to be around 5% of GDP in 2010. The forecast rise in unemployment will maintain upward pressure on social spending. But the very low levels of debt mean that the government can afford to rely on the cyclical recovery to reduce the deficit ratio.

- The outlook for the financial sector is key to our medium-term forecast. While it is not expected to return to the pre-crisis boom years, Luxembourg should be able to gain from the EU's clampdown on tax havens by attracting onshore fund management business. Luxembourg has accommodated EU requirements for improved transparency and regulation, and will continue to attract and retain financial business despite the erosion of former tax and secrecy advantages. New business opportunities will arise from alternative investment funds moving back "onshore" due to new EU regulation: while some financial business will continue to migrate to offshore jurisdictions that have survived the OECD clampdown, Luxembourg is well placed to be their EU administrative centre.

Ernst & Young — Quality In Everything We Do

Oxford Economics

Slow recovery in financial services to weigh on growth



GDP follows global downturn in finance first, in industry next ...

The 4% GDP decline in Luxembourg in 2009 matched that of the Eurozone as a whole, and reflects the economy's high degree of openness to trade and capital flows within the zone. It represents a relatively light escape given that the economy's new core (financial services) and its old core (steel) were both seriously affected by the global banking crisis and subsequent downturn in global industrial production.

Luxembourg's recession started with a sharp fall in exports of financial services already in mid-2008. But during 2009, the economy was mainly hit by lower exports of goods. These have rebounded sharply in Q3 which, along with a more moderate recovery on the services side, sent GDP 4% higher than in the previous quarter. Private consumption has also bounced back in recent quarters but investment was still falling by Q3.

... and recovery will be gradual ...

We estimate that GDP growth fell back in Q4 as the initially sharp recovery in global industry abated somewhat at the end of last year. Luxembourg's business surveys support this view: despite an improvement in overall confidence, businesses continued to report very low order books to the end of 2009.
At the beginning of this year, growth probably remained muted. In industry and construction, production was hindered by unfavourable weather. In the financial sector, balance sheets of financial insitutions were still 13% smaller than a year earlier in February. This is somewhat better than the 20% fall recorded at the end of last year but suggests that activity is picking up slowly.

Growth is likely to be below the 2% official projection in 2010 as a whole. Investment is expected to be the main drag to growth this year. Although capacity utilization has risen from a trough at 65% in mid-2009, it remains 6% points below its historical average level. Companies are likely to want to utilize existing capacity more in order to recoup losses in profitability, before investing in new equipment. Depressed investment will partly offset the effects of the expansionary fiscal policy and recovering net exports.

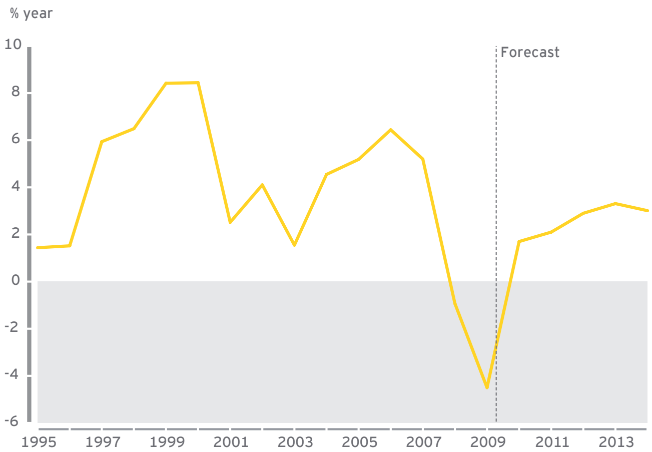
The renewed expansion of service exports (140% of Luxembourg's GDP) will boost economic growth in 2011. But it is only in 2012, when higher exports and a stabilized banking sector start to promote domestic investment, that GDP growth will return to its sustainable trend rate, now about 3%.

Table 1
Luxembourg (annual percentage changes unless specified) *Source: Oxford Economics*

	2009	2010	2011	2012	2013	2014
GDP	-4.5	1.7	2.1	2.9	3.3	3.0
Private consumption	-3.9	1.1	2.7	3.3	3.0	3.1
Fixed investment	-16.5	1.8	3.0	6.0	5.0	4.0
Stockbuilding (% of GDP)	0.4	0.4	0.4	0.4	0.3	0.3
Government consumption	1.9	2.3	3.4	3.6	3.0	3.1
Exports of goods and services	-8.9	3.1	3.8	5.3	5.7	5.3
Imports of goods and services	-11.0	3.2	4.5	6.3	6.3	5.8
Consumer prices	0.0	2.0	2.2	2.0	2.0	2.0
Unemployment rate (level)	5.7	6.4	5.9	5.4	5.0	4.5
Current balance (% of GDP)	8.2	9.6	10.6	12.3	12.6	12.8
Government budget (% of GDP)	-3.0	-4.5	-3.7	-2.5	-1.5	-1.0
Government debt (% of GDP)	18.2	22.1	24.8	26.2	26.3	26.1
ECB main refinancing rate (%)	1.1	1.0	1.6	3.3	4.3	4.3
Euro effective exchange rate (1995=100)	129.7	124.8	122.0	119.7	117.7	116.3
Euro-US dollar exchange rate ($ per €)	1.39	1.34	1.32	1.30	1.29	1.27

Figure 1

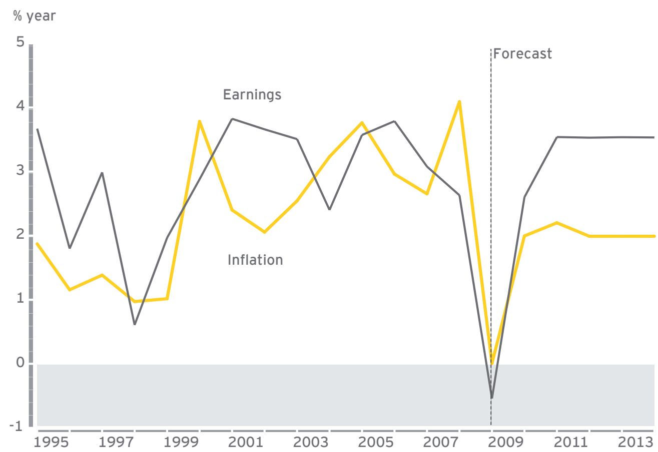
Real GDP



Source: Oxford Economics

Figure 2

Inflation and earnings



Source: Oxford Economics

Weak labor market has little impact on inflation

Last year's downturn brought inflation to a halt, with the consumer price index actually falling from May to July. But inflation rose sharply again to 2%-3% in the first months of this year due to the sharp bounce-back in energy price inflation (8.8% in February from -20%+ in May-July 2009). Meanwhile, core inflation is slowly edging downwards, having fallen below 2% in February for the first time since 2000.

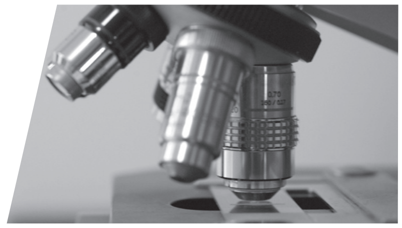
We forecast 2% inflation in 2010 as a whole, somewhat higher than the 1% annual average rate forecast for the Eurozone. Due to lower tax levels, the pass-through of world-traded oil prices to consumer energy prices is quicker in Luxembourg than in the rest of the Eurozone. This year's forecast 30% rise in crude oil prices in euro terms will therefore push inflation up in Luxembourg more than in other countries. More fundamentally, core inflation is unlikely to move down as much in Luxembourg as in the rest of the Eurozone. Indeed, although official unemployment has risen from the long-standing average of 3% to around 6%, many of those without work are not qualified to compete for jobs in finance or engineering, whose holders' bargaining power remains strong. Moreover, de facto wage indexation is common in Luxembourg and will imply higher wage settlements this year. We forecast a rise in average earnings of 2.6% this year which will put a floor on core inflation.

Relatively high inflation has little impact on consumer spending given that it mainly comes from higher wages. Luxembourg's financial services do not compete on price either. But the country's industry, in particular steel, is very price sensitive. The forecast rise in costs coming on the top of an already high base level implies that Luxembourg's traditional industry will struggle to compete against Asian producers.

... but external surplus stays intact, and fiscal deficit is only cyclical

The long-standing fiscal surplus turned to deficit last year due to the assistance that was given to the banks. The government was forced to join a three-country rescue of Fortis, a major commercial bank and insurer, prompting a rare call on the sovereign Eurobond market as its budget moved into deficit.

The deficit will widen significantly this year, owing to cyclical increases in social spending and reductions in tax revenue. We expect the deficit to reach around to 5% of GDP in 2010. But with a very low public debt (still below 10% of GDP going into the downturn), the government can afford to maintain fiscal support in 2010-12 and to rely mainly on stronger growth to narrow the deficit.



Slow recovery in financial services to weigh on growth

The gap is expected to fall below 3% of GDP before any "excessive deficit" procedure becomes necessary — avoiding embarrassment to the member-state whose Prime Minister, Jean-Claude Juncker, last year retained the Eurogroup chair until 2012. Public debt is set to rise in the longer term as the public purse absorbs higher pension costs, and further welfare reform may be needed to ensure full funding of social expenditures as the population ages. But relatively strong public finances remove any danger that present tax advantages will be lost due to fiscal stress.

… and recovery will rely on regulations and resources rather than low taxes

The financial sector experienced severe retrenchment in 2008-09, as private banking and fund management caught the after-effects of the commercial banking downturn elsewhere in the Eurozone. The longstanding reputation for investor protection was dented by various litigations over Luxembourg-based feeder funds for the fraudulent Madoff Investment Securities, even though none is expected to succeed. After investing heavily (especially in IT and regulatory compliance) in 2006-08, financial institutions began cost-cutting in 2009.

In the longer term, Luxembourg remains relatively well placed to attract additional fund management business. It has been helped by internationally coordinated tightening of tax and regulatory rules which will make some offshore "tax havens" less attractive, and is now able to offer administrative services for funds that continue to operate in lower-tax locations. Hedge funds now account for 9%-10% of total funds under management in Luxembourg, a consequence of re-onshoring as well as new launches.

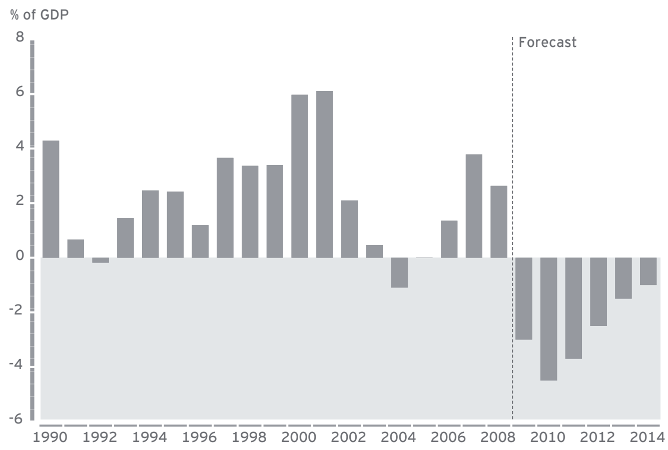
Already an established host of alternative investment funds (those charging high performance fees and attracting specialist investors), Luxembourg is now building up a base of regulated specialist investment funds (SIFs) which can attract capital from retail investors. Rule changes are now being developed to attract Islamic fund management, banking and insurance, of which Luxembourg's market share is already Europe's highest at an estimated 7%. Closer links with new fund types will help the private banking industry build market share among the growing number of high net-worth individuals from outside Europe and America.

Legal changes in early 2007 greatly reduced the time and cost needed to launch a regulated SIF. But 2010 is likely to be the last year in which multinationals can gain significant withholding-tax advantages from Luxembourg-based holding companies, and the new EU rules are likely to erode banking-secrecy advantages. The country's future competitiveness as a financial centre will be much more reliant on advanced communication skills and light but effective regulation than on the tax advantages that attracted funds in the past.

Overall, we forecast robust growth in export of services, at around 8% per annum in nominal terms. While this is much lower than the 20%-30% growth rates experienced in the years prior to the crisis, it will ensure that Luxembourg enjoys one of the fastest GDP growth rates in the Eurozone.

Figure 3

Government budget balance



Source: Oxford Economics

Ernst & Young Luxembourg contacts

Alain Kinsch
Country Managing Partner
+352 42 124 8154
alain.kinsch@lu.ey.com

Elisa Alonso Sanz
Senior Manager
+352 42 124 8408
elisa.alonso-sanz@lu.ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

EYG No. AU0511

In line with Ernst & Young's commitment to minimize its impact on the environment, this document has been printed on paper with a high recycled content.

About Oxford Economics

Oxford Economics was founded in 1981 to provide independent forecasting and analysis tailored to the needs of economists and planners in government and business. It is now one of the world's leading providers of economic analysis, advice and models, with over 300 clients including international organisations, government departments and central banks around the world, and a large number of multinational blue-chip companies across the whole industrial spectrum.

Oxford Economics commands a high degree of professional and technical expertise, both in its own staff of over 70 professionals based in Oxford, London, Belfast, Paris, the UAE, Singapore, New York and Philadelphia, and through its close links with Oxford University and a range of partner institutions in Europe and the US. Oxford Economics' services include forecasting for 190 countries, 85 sectors, and over 2,500 cities sub-regions in Europe and Asia; economic impact assessments; policy analysis; and work on the economics of energy and sustainability.