Creditreform Sovereign Rating

Creditreform Rating
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Rating Object	Rating Information	
GRAND DUCHY OF LUXEMBOURG	Assigned Ratings/Outlook: **AAA /stable**	Type: Follow-up Rating, unsolicited
Long-term sovereign rating Foreign currency senior unsecured long-term debt Local currency senior unsecured long-term debt	Initial Rating Publication Date: Rating Renewal: Rating Methodologies:	29-07-2016 01-06-2018 “Sovereign Ratings”

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Rating Action

Neuss, 01 June 2018

Creditreform Rating has affirmed the unsolicited long-term sovereign rating of “AAA” for the Grand Duchy of Luxembourg. Creditreform Rating has also affirmed Luxembourg’s unsolicited ratings for foreign and local currency senior unsecured long-term debt of “AAA”. The outlook is stable.

Key Rating Drivers

1. Luxembourg should continue to outperform most euro area peers on metrics such as per-capita income, GDP growth and unemployment, though macro-financial risks pertaining to heavy reliance on financial services and rising indebtedness of households persist
2. Exceptionally high quality of institutional conditions and an extraordinarily high degree of political stability coupled with extensive economic benefits from integration in the European Union and the euro area
3. Track record of sound fiscal policies mirrored by recurrent budgetary surpluses, very low debt levels and high debt affordability; strong fiscal buffers enable the government to shield the domestic economy in the event of a major crisis in the very large financial sector
4. Sustained current account surpluses and a positive net international investment position; however, elevated volatility stemming from large underlying external asset and liability positions

Reasons for the Rating Decision

The Grand Duchy of Luxembourg’s credit rating continues to be underpinned by the economy’s strong macroeconomic performance. Our macroeconomic assessment reflects very high levels of productivity and prosperity, a track record of robust GDP growth and well-performing labor markets. These credit strengths are set against risks related to a lack of economic diversification and high levels of private sector debt.

We note that the country features a very wealthy economy, with GDP per capita estimated at USD 106,374 (2017, in PPP terms) – the third highest in the world and the highest in the EU-28 by far. Per capita income continues to mirror labor productivity per person

which stands well above EU-28 levels (2016: 163.2% of EU-28), and a strong presence of high value-added services in the economy. As revealed by Eurostat data, financial and insurance activities accounted for more than a quarter (26.5%) of gross value added and 10.9% of total employment in 2017 – both the highest share in the EU-28 (4.8%; 2.5%). While being an essential building block of the economy's prosperity, we believe that its heavy reliance on financial services exposes the economy to elevated risks associated with sudden swings in financial market sentiment, asset price volatility, and evolving regulation of global financial markets.

Though displaying very high per capita income levels, Luxembourg experienced above average GDP growth in recent years. In 2012-16, real GDP expanded on average by 3.0%, comparing favorably with 0.8% in the euro area. However, in 2017 growth surprised on the downside and moderated to 2.3% (2016: 3.1%). To be sure, GDP growth figures were subject to frequent revisions in the past due to considerable time lags in data availability. The slowing growth momentum was largely explained by a weak performance of the financial sector and a lower growth contribution from external trade. After having decelerated from 2.4 to 1.3% in 2015-16, the growth rate of gross value added by financials turned negative last year, posting at -3.3%. In particular, increasing regulatory costs and higher spending on digitization negatively impacted value added of banks. At the same time, the growth contribution from net exports fell from 2.0 to 1.4 p.p., mainly due to vividly growing imports. By contrast, domestic demand firmed last year, supported by a moderate recovery in investment activity and robust consumer spending. Gross fixed capital formation, which had stagnated in 2016 (-0.5%), saw a modest turnaround and grew by 1.9% on the year. Significantly higher spending on machinery and equipment (+11.2%) was partly offset by lower construction and intellectual property investment, which contracted by 0.8 and 17.2% respectively. Private consumption maintained its momentum, fueled by ongoing employment growth and modestly rising real wages. Effective from January 2017, the minimum social wage was hiked by 1.4%. Moreover, the national wage indexation mechanism was triggered, leading to an additional 2.5% raise in pensions and salaries. Thus, nominal wages grew more dynamically than consumer prices, which edged up to 2.1% after having stagnated in 2015-16.

Looking ahead, we expect that economic activity is set to accelerate this year, with economic output expanding by 3.8% on the back of both higher domestic demand and net exports. According to STATEC, the next automatic indexation of wages, salaries and pensions can be expected in Q3-18, while the labor market should continue to perform well. Our expectation is underpinned by robust retail sales in Q1-18, as well as strong consumer sentiment, which both point to sustained growth in private consumption expenditures. Investment should step up a gear, driven by a corporate tax relief (see below), NFC lending rates which are among the lowest in the euro area, and capacity constraints in the manufacturing sector. As indicated by Eurostat data, capacity utilization posted at a high 82.0% in Q2-18 and well above the 10-year average of 74.4%. Concurrently, external demand should remain buoyant against the backdrop of favorable developments in international trade and benign growth prospects for Luxembourg's main trading partners. Assuming no sudden and exceptional increase in financial market volatility,

financial service exports should grow at robust rates and more than offset higher import demand. Hence, net exports are likely to have a stronger impact on growth than in 2017.

With regard to next year, the maturing economic recovery in the euro area and less dynamic job creation should somewhat weigh on exports and private consumption. Thus, we anticipate growth to pull back to 3.6% before gradually converging towards the economy's potential growth rate in the following years. Still, at around 3% (European Commission estimates), we consider Luxembourg's potential growth to be strong – taking into account its already high level of economic development. In recent years, potential growth has been driven by rapidly growing employment and to a lesser extent by investment. In 2017, job creation gathered steam, with total employment (domestic concept) expanding by 3.3%, up from 3.0 and 2.6% in 2015/16. Continuing job growth translated into improving unemployment figures. After having peaked at 6.5% three years ago, unemployment fell to 6.3 in 2016 and to 5.6% in 2017. Thus, Luxembourg's jobless rate was among the lowest in the euro area (2017: 9.1%), although it has still not reached its pre-crisis levels (avg. 2003-07: 4.4%) yet. However, it is also worth pointing out some entrenched weaknesses in the labor market, such as a high gender gap in part-time employment and the relatively low participation rate of the older population. As of 2017, only 41.1% of older workers (55-64y) participated in the labor market, which compares low by euro area standards (61.3%). Low participation rates within these groups can be partly explained by disincentives to work embedded in the pension and tax regime. While the pension system still offers various early retirement schemes, labor market integration of women could benefit from legislative changes introduced in 2018. Alongside the provision of expanded childcare services, married taxpayers are now able to opt for individual taxation, which could strengthen working incentives for second income earners.

Turning to investment, recent developments give a mixed picture. While the government's capital expenditures of 4.0% of GDP remained higher than in the euro area (2.6% of GDP) in 2017, the private investment-to-GDP ratio was comparatively low and continued on its downward trajectory. At 13.0% of GDP last year, private investment was not only lagging the euro area by some 5 p.p. but was also lower than a decade before (2008: 16.6% of GDP). What is more, we assess that R&D expenditures in the business sector have trended downward since 2008, while enterprises in the Netherlands, Germany and France ramped up their spending on research as measured by GDP. However, we acknowledge that the government is aware of this issue and has implemented measures to stimulate innovation in the domestic corporate sector. Back in May-17, the government overhauled and amended its SME support framework. Among others, the accessibility to R&D support schemes was broadened. In Dec-17, the parliament approved the full deductibility of R&D expenses and introduced a new tax credit on software purchases.

That being said, our institutional assessment reflects our opinion that Luxembourg is a main beneficiary of the European Single Market and the European Monetary Union. Being a small, open economy specialized in the provision of cross-border financial services, the country benefits extensively from unrestricted labor and capital flows, as well as from euro area membership, which entails broader and deeper capital markets.

The very high quality of Luxembourg's institutional setting remains a key support to its credit rating. Assessing the World Bank's World Governance Indicators (WGIs), we note that Luxembourg outperforms most EA-19 members, and that the sovereign's performance across most WGI dimensions is consistent with AAA-rated peers Denmark, the Netherlands, and Germany. The sovereign is characterized by a high degree of effectiveness and credibility when it comes to policy formulation and implementation (WGI rank 15) and achieves even higher scores with regard to perceived corruption and democratic participation. In the World Bank's 2017 report, Luxembourg was listed 6th and 8th on the indicators "Control of Corruption" and "Voice & Accountability". This compares not only favorably with EA-19 median ranks of 41 and 29 respectively, but also puts the sovereign in the top decile on a global perspective. We believe that these characteristics, complemented by the country's geographic location in the heart of Europe, will continue to support the political stability which is reflected by a track record of stable governments, and the absence of social unrest and external conflicts.

Although Luxembourg is a frontrunner in terms of institutional quality, the country still has room to improve its business environment. Ranking 63rd out of 180 countries, Luxembourg's performance on the World Bank's Doing Business indicators falls short of its AAA-rated peers. For instance, insolvency procedures are less efficient and capital requirements to start a business are higher than in comparable high-income economies such as Germany and the Netherlands. Fostering the business environment would likely facilitate the implementation of the administration's "Research and Innovation Smart Specialisation Strategy" (RIS3). The strategy, published by the Ministry of Economy in Dec-17, defines five fast-growing, high value-added key industries (ICT, logistics, health, space and eco technologies), which should be promoted in order to achieve a higher degree of economic diversification. This appears particularly important given that the international tax transparency agenda is putting one of the economy's key competitive edges at risk, namely its corporate tax framework.

To be sure, Luxembourg has been an attractive destination for intellectual property (IP) on-shoring in the past, due to the country's favorable patent box regime and the fact that it is not charging withholding taxes on royalties and interest. It has to be emphasized, however, that the government is actively engaging in international efforts to fight tax evasion and aggressive tax planning. The government passed the EU's Fourth AML/CFT directive in Feb-18 and also voted to overhaul the national IP tax regime (Mar-18) to align it with international standards defined by the OECD/G20 BEPS project. Under the new legal framework, an entity is only allowed to benefit from the IP regime to the extent that the taxpayer itself incurred qualifying R&D expenditure that gave rise to the IP income. Entities owning IP assets that benefited from the former IP regime continue to do so during a transitional period ending in June 2021. Looking ahead, authorities plan to adopt the EU's Anti-Tax Avoidance Directives (ATAD I and II) by the end of 2019.

As regards Luxembourg's fiscal metrics, its budgetary performance surprised on the upside last year, with the surplus on the general government level stabilizing at 1.5% of GDP (2016: 1.6%), while authorities had expected a surplus of 0.6% (Draft Budgetary Plan 2018). Budgetary outperformance came on the back of stronger-than-expected rev-

enue growth which was broadly aligned with rapidly rising government expenditure. Despite the introduction of some revenue-decreasing measures, such as a lower CIT rate and some tax relief for start-ups, revenues grew by 6.0%, the strongest increase since 2011 (+6.0%). Taxes on income and wealth, which include tax receipts by enterprises, posted annual growth of 6.6% (2016: +7.5%). Also, VAT receipts, which had been falling in 2015 and 2016, returned to growth (+2.0%) although Luxembourg's retained VAT share from e-commerce transactions fell from 30% to 15%. Most importantly, social contributions performed exceptionally well. Growth in net social contributions more than doubled from 3.2 to 7.0% in 2017, reflecting strong job creation, as well as increasing nominal wages in the aftermath of the automatic wage indexation. At the same time, the latter also pushed up government outlays. Social benefits and compensation of public servants, together making up for two thirds (68%) of overall spending, picked-up significantly and expanded by 6.0 and 8.3%, respectively (2016: +1.8 and 1.9%). Public investment also contributed to last year's acceleration in expenditure growth. On the whole, total outlays rose by 6.0%, well above the annual average of 4.1% observed in 2012-16.

With regard to 2018, we expect the sovereign's budgetary position to weaken somewhat, assuming the materialization of our growth forecast and no major revisions to 2017 GDP figures, which could significantly affect the headline balance via the denominator effect. While we expect the social security funds to maintain their surplus, both expenditure and revenue should contribute to a widening in the central government's budget deficit. State revenues should evolve at a solid pace but less dynamic than in 2017, as another cut in the CIT rate from 19 to 18% entered into effect in Jan-18. Moreover, the expansion of childcare services implemented in the second half of 2017 will impact the state budget. Parents of children between the ages of one and four are now entitled to 20 hours of free childcare per week. Apart from that, we expect investment to step up a gear after some project delays dampened the government's capital spending in 2017. In light of strong population growth and the government's diversification plans, large-scale infrastructure investment is set to continue over the coming years. Currently, Luxembourg is heavily investing in an upgrade of railway tracks and stations as well as public transport ("Luxtram"). As a result, the surplus on the general government level should edge down to 1.0% of GDP in 2018 and 0.8% in 2019. Still, this would imply a significant margin of safety against the provisions in the EU's Stability and Growth Pact.

In the same vein, the sovereign's debt-to-GDP ratio, one of the lowest in the euro area, should remain broadly stable in the medium term. Although Luxembourg's general government accounts exhibited a sizeable fiscal surplus, public debt increased from 20.8 to 23.0% of GDP last year, as surpluses run by social security funds have to be transferred to the pension reserve fund and cannot be used to fund the central or local governments under national laws. Low debt levels are complemented by excellent affordability metrics. According to our calculations, the government's interest-to-revenue ratio of 0.8% in 2017 was the second lowest in the euro area, mirroring the sovereign's ability to issue long-term bonds at very favorable rates. As of the end of April 2018, the LUGV 0.625 government bond maturing in 2027 yielded 0.65% as compared with 0.55% one year before.

Notwithstanding healthy public finances, we continue to see some, albeit moderate, fiscal sustainability risks arising from the projected increase in age-related spending, in particular pension outlays. However, the country's demographic profile compares relatively favorably with European peers. Standing at 20.5%, Luxembourg's old-age dependency ratio was the lowest in the EU-28 last year, as the negative impact of an ageing population on labor supply has been offset by sustained net migration so far. Positive demographics are also reflected in a moderate level of age-related spending, which totaled 18.1% of GDP in 2016, some 3 p.p. below the EU-28 median (21.3%). Against the background of this relatively favorable initial position, the projected increase in demographic cost of 1.3 p.p. of GDP up to 2030 appears manageable.

Aside from demographics, we believe that the size of Luxembourg's financial sector carries a serious risk to fiscal sustainability in the event of rising volatility and financial market distress. Assets of monetary and financial institutions and investment funds exceeded GDP by factor 19 and 75 respectively in 2017. Risk is further compounded by extensive financial linkages between investment funds and banks. At this stage, however, both the fund industry and the banking sector, which is dominated by foreign branches, appear well-positioned. While investment funds recorded significant net inflows, equating to EUR 418.3bn (+11.2% y-o-y) in 2017, financial soundness indicators signal that the banking sector remains in good shape. The CET1 capital ratio stayed above the 20%-mark, posting at 20.4% in Q4-17, while asset quality remained excellent as indicated by the lowest NPL-ratio in the EU-28. Non-performing loans continued to decline from 1.0% in Q4-16 and made up for only 0.7% of total loans outstanding end of 2017.

While bank balance sheets appear solid, indebtedness in the private sector, which amounted to 471.7% of GDP in Q4-17 (Eurostat, non-consolidated financial accounts) - the highest in the euro area - implies elevated vulnerabilities. Despite the recent decline from 417.2 (Q4-16) to 404.9% of GDP at the end of 2017, corporates continue to account for the bulk of private debt, mirroring the presence of significant multinational treasury operations in Luxembourg. Concurrently, household debt remained on an upward trajectory, climbing from 65.3 to 66.8% of GDP. Although household debt is broadly in line with EA-19 levels (64.1% of GDP), we believe that the rapid debt accumulation in combination with the brisk housing price development warrants some caution. In 2007-16, the debt stock of households' as measured by GDP edged up by 15 p.p., while the gross debt-to-income ratio increased by some 40 percentage points to 171.7%. Debt accumulation was in particular driven by strong mortgage lending activity, which continued to post growth rates in the 7-8% range throughout 2017. Driven by a growing population and low interest rates, but also by supply bottlenecks, housing prices have increased rapidly since 2013. To be sure, y-o-y-growth moderated from 5.9% in 2016 to 4.1 % in 2017. Still, the Luxembourgish housing market has experienced a sharp increase in real prices of 20.5% as compared with 2013, and the price-to-income and price-to-rent ratio stood 18.8 and 18.5% above their long term average in Q4-17 (OECD data), signaling a deterioration in affordability.

Similar to its AAA-rated peers, Luxembourg's external accounts are characterized by a net foreign asset position and sustained current account surpluses, which provide some

buffer against external shocks. Luxembourg is traditionally running a negative trade in goods balance, as well as a large primary income deficit which is more than compensated by significant net exports of services – in particular from the financial sector. On average, approx. 70% of the economy's trade in services surplus can be attributed to financial activities over the last decade. As regards 2017, external developments remained consistent with this pattern. The current account surplus, which came in at 6.4% of GDP in 2016, decreased to a still high 5.0% as stronger net receipts from service exports did not offset a widening trade in goods and primary income deficit. While the trade in goods deficit increased from 6.7 to 7.5% of GDP, the primary income balance, which mirrors a large foreign workforce as well as investment fund and multinational treasury operations, fell from -28.5% in 2016 to -29.9% of GDP. Meanwhile, the economy's net foreign asset position remained broadly stable at 42.3% of GDP last year (2016: 41.5% of GDP). However, Luxembourg's NIIP experienced sharp swings due to FX movements, investor sentiment, and MNE financing decisions in the past and we believe that these factors remain a source of volatility going forward. In general, the economy features a negative portfolio investment position, while being an international creditor in terms of FDI. Last year, FDI assets and liabilities amounted to 9005.3 and 7867.3% of GDP respectively. Large gross positions in FDI are mainly stemming from a significant number of SPEs incorporated in Luxembourg. According to Banque de Luxembourg data, SPEs such as holdings and financial auxiliaries, accounted for more than 95% of FDI assets and liabilities at the end of 2017.

Rating Outlook and Sensitivity

Our Rating outlook on the long-term sovereign rating is stable, as we assume that the risk situation underlying the key factors affecting sovereign credit risk – including macroeconomic performance, institutional structure, fiscal sustainability, and foreign exposure – is likely to remain fundamentally unchanged in the next 12 months.

We could consider lowering our rating on the Grand Duchy of Luxembourg if real GDP significantly falls short of our current expectations in the medium term. The very high degree of trade openness leaves the economy susceptible to a slowdown of growth in the EU, as well as to the implementation of protectionist policies. Apart from that, a downgrade could occur if we observe fiscal slippages over an extended period of time, complemented by rapidly increasing public debt. Furthermore, changes in global taxation standards and financial sector regulation could endanger the country's attractiveness for FDI and in turn have a detrimental effect on tax revenues. As of 2016, banks, investment funds and insurance companies made up for 14.5% of total tax receipts.

Brexit may have ambiguous effects in terms of the eventual impact on Luxembourg's financial system. Depending on the final negotiation outcome, we could see some financial service providers relocate from the UK in order to keep their passporting rights. On the other hand, we believe that Luxembourg's financial sector could suffer from a sudden increase in risk aversion should there be increasing signs of a disorderly Brexit. Asset fire sales by international investors would not only hit the domestic fund industry, but could also have negative repercussion to banks, which have strong linkages to funds. At the

current junction, our baseline scenario assumes an orderly exit of the UK in March 2019, given the recent progress that has been made in Brexit negotiations between the EU and the United Kingdom (see also UK long-term sovereign rating, 30 March 2018).

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Ratings*

Long-term sovereign rating	AAA /stable
Foreign currency senior unsecured long-term debt	AAA /stable
Local currency senior unsecured long-term debt	AAA /stable

*) Unsolicited

Economic Data

	2012	2013	2014	2015	2016	2017	2018e
Real GDP growth	-0.4	3.7	5.8	2.9	3.1	2.3	3.8
GDP per capita (PPP, USD)	92,102	94,824	99,738	101,255	103,286	106,374	110,870
HICP inflation rate, y-o-y change	2.9	1.7	0.7	0.1	0.0	2.1	1.4
Default history (years since default)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Life expectancy at birth (years)	81.5	81.9	82.3	82.4	82.7	n.a.	n.a.
Fiscal balance/GDP	0.3	1.0	1.3	1.4	1.6	1.5	1.0
Current account balance/GDP	5.6	5.5	5.2	5.1	6.4	5.0	n.a.
External debt/GDP	5489.6	5591.0	6673.8	6940.6	7086.9	6306.7	n.a.

Source: International Monetary Fund, Eurostat, own estimates

Appendix

Rating History

Event	Publication Date	Rating /Outlook
Initial Rating	29.07.2016	AAA /stable
Follow-up Rating	30.06.2017	AAA /stable
Follow-up Rating	01.06.2018	AAA /stable

Regulatory Requirements

In 2011 Creditreform Rating AG (CRAG) was registered within the European Union according to EU Regulation 1060/2009 (CRA-Regulation). Based on the registration Creditreform Rating AG is allowed to issue credit ratings within the EU and is bound to comply with the provisions of the CRA-Regulation.

This sovereign rating is an unsolicited credit rating. Neither the rated sovereign nor a related third party participated in the credit rating process. Creditreform Rating AG had no access to the accounts, representatives or other relevant internal documents for the rated entity or a related third party. Between the disclosure of the credit rating to the rated entity and the public disclosure no amendments were made to the credit rating.

The rating was conducted on the basis of CRAG´s “Sovereign Ratings” methodology in conjunction with its basic document “Rating Criteria and Definitions”. CRAG ensures that methodologies, models and key rating assumptions for determining sovereign credit ratings are properly maintained, up-to-date, and subject to a comprehensive review on a periodic basis. A complete description of CRAG´s rating methodologies and basic document “Rating Criteria and Definitions” is published on the following internet page: www.creditreform-rating.de/en/regulatory-requirements/.

To prepare this credit rating, CRAG has used following substantially material sources: International Monetary Fund, World Bank, Organization for Economic Co-operation and Development, Eurostat, European Commission, European Banking Authority, European Central Bank, Banque de Luxembourg, Institute national de la statistique et des étude économiques (STATEC), Ministry of Finance.

A Rating Committee was called consisting of highly qualified analysts of CRAG. The quality and extent of information available on the rated entity was considered satisfactory. The analysts and committee members declared that the rules of the Code of Conduct were complied with. No conflicts of interest were identified during the rating process that might influence the analyses and judgements of the rating analysts involved or any other natural person whose services are placed at the disposal or under the control of Creditreform Rating AG and who are directly involved in credit rating activities or approving credit ratings and rating outlooks. The analysts presented the results of the quantitative and qualitative analyses and provided the Committee with a recommendation for the rating decision. After the discussion of the relevant quantitative and qualitative risk factors, the Rating Committee arrived at a unanimous rating decision. The weighting of all risk factors is described in CRAG´s “Sovereign Ratings” methodology. The main arguments that were raised in the discussion are summarized in the “Reasons for the Rating Decision”.

As regards the rating outlook, the time horizon is provided during which a change in the credit rating is expected. This information is available within the credit rating report. There are no other attributes and limitations of the credit rating or rating outlook other than displayed on the CRAG website. In case of providing ancillary services to the rated entity, CRAG will disclose all ancillary services in the credit rating report.

The date at which the credit rating was released for distribution for the first time and when it was last updated including any rating outlooks is indicated clearly and prominently in the rating report; the first release is indicated as “initial rating”; other updates are indicated as an “update”, “upgrade or downgrade”, “not rated”, “affirmed”, “selective default” or “default”.

In accordance to Article 11 (2) EU-Regulation (EC) No 1060/2009 registered or certified credit rating agency shall make available in a central repository established by ESMA information on its historical performance data, including the ratings transition frequency, and information about credit ratings issued in the past and on their changes. Requested data are available on the ESMA website: https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

An explanatory statement of the meaning of each rating category and the definition of default are available in the credit rating methodologies disclosed on the website.

Disclaimer

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