

Luxembourg RAC

Fitch Ratings has affirmed Luxembourg's Long-term foreign and local currency Issuer Default Ratings (IDRs) at 'AAA'. The Outlooks on the IDRs are Stable. Fitch has simultaneously affirmed Luxembourg's Country Ceiling at 'AAA' and Short-term foreign currency IDR at 'F1+'.

"Luxembourg's 'AAA' rating is underpinned by its developed open economy, high income, robust economic growth, low public debt and net external creditor status, " says Gergely Kiss, Director in Fitch's Sovereign group. "The financial sector, which is exceptionally large as Luxembourg is the centre of the EU investment funds industry, has largely recovered from the crisis, underpinning the resilience of Luxembourg's economic model" adds Kiss.

Luxembourg's economy grew at 3.5% in 2010, significantly above the euro area average of 1.7%. Buoyant growth since Q4 09 means that the level of GDP exceeded the peak before the financial crisis of 2008 by end-2010. Fitch expects even higher growth in 2011 of 3.8%, though mainly on account of strong base effects from Q4 2010. Beyond 2011, however, Fitch forecasts a gradual slowdown of the economy, in line with the weaker euro area outlook.

Luxembourg has an impressive track record of prudent fiscal policy. General government debt was 18% of GDP in 2010, the lowest among 'AAA' rated sovereigns. After a long period of budget surpluses before the financial crisis of 2008, the budget deficit remained modest during the recession, peaking at 1.7% of GDP in 2010. Nevertheless, in the long term Luxembourg has to address sizeable contingent liabilities in its pension system. The combination of generous pension rules and the ageing society would, in a no-policy-change scenario, lead to unsustainable debt dynamics, even taking into account the social security reserves that reached 28% of GDP in 2010.

Total banking profit increased by 87% in 2010 from 2009, though spread unevenly, and overall system capital adequacy remained stable. Investment funds' activity exceeds pre-crisis peaks both in term of total assets and number of funds. Nonetheless, given the financial sector's dominant role, the economy remains exposed to financial stability risks. An important lesson from the 2008-09 financial crisis is that shocks outside the authorities' control could trigger a need for public intervention and recapitalization, leading potentially to a sharp increase in public debt.

Luxembourg has a very strong external balance sheet. Its net international investment position was equal to 96% of GDP in 2010. The current account has been in surplus for more than twenty years and reached 7.8% of GDP in 2010.

Furthermore, Luxembourg ranks highly on all World Bank governance indicators, in line or exceeding 'AAA' medians. Its institutional strengths foster confidence in its ability and willingness to honour its public debt commitments.