

PRESS RELEASE

NOVEMBER 10, 2023

DBRS Morningstar Confirms Grand Duchy of Luxembourg at AAA, Stable Trend

SOVEREIGNS

DBRS Ratings GmbH (DBRS Morningstar) confirmed the Grand Duchy of Luxembourg's Long-Term Foreign and Local Currency – Issuer Ratings at AAA. At the same time, DBRS Morningstar confirmed the Grand Duchy of Luxembourg's Short-Term Foreign and Local Currency – Issuer Ratings at R-1 (high). The trend on all ratings is Stable.

KEY CREDIT RATING CONSIDERATIONS

The confirmation of the Stable trend reflects DBRS Morningstar's view that the credit fundamentals of Luxembourg remain solid, notwithstanding a temporary softening of economic growth dynamics and a moderate increase in budgetary pressures. Economic growth has weakened since late last year with real GDP forecast to contract by 0.4% in 2023 after expanding by 1.4% in 2022. This weakening in growth dynamics has been driven by lower external demand for service exports and a softening of domestic investment activity whereas private consumption has held up comparatively well. Looking ahead, real GDP is forecast to rebound by 1.5% in 2024 as service exports are projected to recover moderately. The general government budget balance is forecast to widen to a still moderate 1.9% of GDP in 2023 from 0.3% in 2022, as the government has stepped up fiscal support measures for households. While budgetary projections by the outgoing government point to a further widening of the deficit to 2.7% of GDP in 2024, these projections do not incorporate any fiscal measures of the new government which is yet to be formed. In DBRS Morningstar's view, Luxembourg has ample fiscal space for absorbing a temporary increase in budgetary pressures due to a low level of public debt and a large stock of government assets.

The credit ratings reflect Luxembourg's very strong public finances. The credit ratings are also supported by its solid institutions and stable political environment, its advanced and wealthy economy, and its strong external position. These credit strengths offset the challenges associated with the country's small economy with limited diversification, its vulnerability to external shocks, and its exposure to potential financial stability risks.

CREDIT RATING DRIVERS

Given Luxembourg's strong fundamentals, DBRS Morningstar sees a downgrade of the credit ratings as unlikely. Nevertheless, a downgrade could result from a severe shock to Luxembourg's large international financial centre, most likely generated by sustained turmoil in financial markets, that could have a significant impact on the economy and on public finances. A downgrade could also come from material damage to Luxembourg's attractiveness as a business hub that could have a similar impact.

CREDIT RATING RATIONALE

Economic Growth Weakened in Recent Months but Is Projected to Recover Next Year

Economic activity has weakened since late 2022. Real GDP contracted by 1.7% during the first half of 2023 on a year-on-year basis,

driven by lower external demand for service exports. In addition, the tightening of financial conditions weighed on domestic investment activity. On the supply side, the slowdown was particularly pronounced in the financial sector and, to a lesser extent, in the trade, transport and accommodation and construction sectors. In contrast, economic growth was supported by private consumption which, while weakening, has held up better than in most other EU countries. This resilience in private consumption can be ascribed to several direct and indirect government support measures which bolstered households' purchasing power such as a temporary reduction of selected VAT rates, the introduction of gas and electricity price caps and the granting of free access to certain services (e.g. public transportation). On an annual basis, the IMF forecast real GDP to decline by 0.4% in 2023 but to rebound by 1.5% in 2024 on the back of a moderate recovery in service exports.

Luxembourg's credit profile continues to be supported by the highly developed nature of its economy and its position as a global financial centre. The country hosts a very large fund industry and numerous international banks and insurers. Financial sector activities accounted for a large 24.3% of total nominal gross value added in 2022 and constitute, together with business services (12.0%), the backbone of the economy. While ongoing changes in global corporate taxation could affect the operations of multinational companies, DBRS Morningstar takes the view that the overall attractiveness of Luxembourg as a financial hub is likely to remain large due to a highly skilled workforce, a strong legal and regulatory environment, and political stability. Furthermore, Luxembourg's exceptionally high GNI per capita provides the country with a significant buffer against shocks. Together, these considerations support DBRS Morningstar's positive adjustment of the 'Economic Structure and Performance' building block assessment.

General Government Budget Balance Is Forecast to Post Moderate Budget Deficits in 2023 and 2024

Budgetary pressures in 2023 have increased, driven by a step-up in energy support measures. The government's draft budget 2024, forecasts the general government budget deficit to widen from 0.3% of GDP in 2022 to 1.9% in 2023 related to higher support measures both on the expenditure and the revenues sides. The IMF estimates the total fiscal cost of energy support measures at 2.2% of GDP in 2023, up from 1.3% in 2022. Although some energy support measures are currently planned to expire in December 2023, the government draft budget forecasts a further widening of the general government budget deficit to 2.7% of GDP in 2024 as a regular adjustment of personal income tax brackets from 2024 onwards is set to weigh on government tax revenues. However, DBRS Morningstar notes that the 2024 budget projections do not incorporate any potential fiscal measures of the new government. Instead, these figures have been prepared by the outgoing government on a no-policy change scenario.

Credit Ratings Continue to Be Underpinned by Low Public Debt and Large Government Assets

The government debt-to-GDP ratio remains among the lowest in Europe. Although the government's debt stock is projected to increase moderately over the next years, the government debt-to-GDP ratio is expected to remain below the country's own ceiling of 30% of GDP. The recently released draft budget 2024 projects general government debt to increase from 24.7% at end-2022 to a still modest 27.8% at end-2024. Moreover, the government's repayment capacity is bolstered by large government assets. At end-2022, the general government had a net asset position of 8.1% of GDP (excluding government shareholdings in several commercial and non-commercial companies). Therefore, DBRS Morningstar assesses Luxembourg's fiscal space as very large.

Change in Government Is Unlikely to Alter Overall Direction of Government Policy

The composition of the government is about to change as the outgoing three-party coalition (Luxembourg Socialist Workers' Party, the Greens, Democratic Party) failed to secure a parliamentary majority in the general elections on 8 October 2023. While coalition talks are still ongoing, the formation of a new government of the centre-right Christian Social People's Party and the liberal Democratic Party is currently the most likely scenario. Despite the change in government, DBRS Morningstar takes the view that overall policy continuity will remain high over the next years. There is a broad consensus among the main political parties on key policy topics, including fiscal, macroeconomic and foreign affairs. The credit ratings are also underpinned by a high institutional

quality. The country is a strong performer on the World Bank's Governance Indicators as it is characterised by a high rule of law and low levels of corruption.

Financial Condition of Banking Sector Is Sound but Risks Might Emerge from a Decline in Housing Prices and High Interest Rates

DBRS Morningstar assesses the overall financial condition of the economy's large banking sector as sound. Banks have comfortable liquidity positions and benefit from good capital buffers, which are an important cushion against a potential weakening of asset quality in the future. The average capital adequacy ratio of domestically-oriented banks amounted to 22.0% in December 2022. The stock of non-performing loans is low but DBRS Morningstar views a potential prolonged correction of domestic housing prices in tandem with rising interest rates as a potential risk factor for banks' asset quality. After increasing markedly over past few years, residential housing prices have decreased with average prices for new and existing dwellings falling by 6.4% between June 2022 and June 2023. The price correction was particularly pronounced for existing houses which registered an average price decline of 13.5%.

Furthermore, the recent increase in interest rates might strain the repayment capacity of some households. The average interest rate on households' outstanding loans rose to 4.0% in September 2023, up from 2.4% a year earlier. At the same time, the repayment capacity of most households is supported by large household assets and a strong labour market as well as wage indexation. Households' aggregate financial net worth (excluding pension and insurance claims) amounted to 59% of GDP in June 2023. In terms of the large investment fund industry, DBRS Morningstar notes that, while the industry has registered net redemptions of fund shares over the past few months, the scale of these outflows was modest and is, therefore, unlikely to have raised liquidity pressures.

The External Position Is Solid and Influenced by the Multinational Sector

Luxembourg's external position benefits from persistent current account surpluses and a large net external asset position. The economy is projected to continue to register large current account surpluses, driven by sizeable net exports of financial services. The IMF forecasts a current account surplus of 3.7% of GDP in 2023 and of 4.0% in 2024, compared with an average annual surplus of 4.4% between 2012 and 2022. The country also remains a net external creditor, with the net international investment position (NIIP) standing at a large 43.4% of GDP in June 2023. Luxembourg's international investment position is heavily influenced by the activities of multinational companies and the financial sector. It commands over a very high net creditor position in direct investments which, according to data by the central bank, largely relates to special purpose vehicles. Instead, the economy exhibits a very large negative portfolio investment position due to a substantial stock of investment fund shares held by non-residents. While Luxembourg is a small economy in a monetary union with limited capacity for external adjustment, the country's extensive financial and trade linkages throughout Europe reduce external risks and support DBRS Morningstar's positive adjustment of the 'Balance of Payments' building block assessment.

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Environmental (E) Factors

There were no Environmental factors that had a relevant or significant effect on the credit analysis.

Social (S) Factors

There were no Social factors that had a relevant or significant effect on the credit analysis.

Governance (G) Factors

There were no Governance factors that had a relevant or significant effect on the credit analysis.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings (04 July 2023) <https://www.dbrsmorningstar.com/research/416784/dbrs-morningstar-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings>

For more information on the Rating Committee decision, please see the Scorecard Indicators and Building Block Assessments.

EURO AREA RISK CATEGORY: LOW

Notes:

All figures are in Euros unless otherwise noted. Public finance statistics reported on a general government basis unless specified.

The principal methodology is the Global Methodology for Rating Sovereign Governments (06 October 2023) <https://www.dbrsmorningstar.com/research/421590/global-methodology-for-rating-sovereign-governments>. In addition, DBRS Morningstar uses the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings <https://www.dbrsmorningstar.com/research/416784/dbrs-morningstar-criteria:-approach-to-environmental,-social,-and-governance-risk-factors-in-credit-ratings> in its consideration of ESG factors.

The credit rating methodologies used in the analysis of this transaction can be found at:

<https://www.dbrsmorningstar.com/about/methodologies>.

The sources of information used for these credit ratings include Luxembourg Ministry of Finance (Draft Budget 2024, October 2023; Stability Programme 2023, April 2023), Trésorerie de l'Etat, National Institute of Statistics and Economic Studies of the Grand Duchy of Luxembourg STATEC (Conjuncture Flash October 2023; Statistical tables), Banque Centrale du Luxembourg (Revue de stabilité financière 2022; Statistical tables), Commission de Surveillance du Secteur Financier (CSSF), European Systemic Risk Board (ESRB Risk Dashboard September 2023), Eurostat, European Commission (European Economic Forecast, Summer 2023), European Central Bank (Statistical Data Warehouse), OECD (Housing Prices), BIS, IMF (2023 Article IV Consultation Report Luxembourg, May 2023; World Economic Outlook October 2023; International Financial Statistics), World Bank, European Environment Agency (EEA Effort Sharing Decision Dataset, October 2023), Social Progress Index, Haver Analytics national statistical agency, central bank, Ministry of Finance, IMF, World Bank, Haver Analytics. DBRS Morningstar considers the information available to it for the purposes of providing these credit ratings to be of satisfactory quality.

With respect to FCA and ESMA regulations in the United Kingdom and European Union, respectively, these are unsolicited credit ratings. These credit ratings were not initiated at the request of the issuer.

With Rated Entity or Related Third Party Participation: YES

With Access to Internal Documents: NO

With Access to Management: NO

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The sensitivity analysis of the relevant key credit rating assumptions can be found at: <https://www.dbrsmorningstar.com/research/423218>.

These credit ratings are endorsed by DBRS Ratings Limited for use in the United Kingdom.

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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

Ratings

Luxembourg, Grand Duchy of

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
10-Nov-23	Long-Term Foreign Currency - Issuer Rating	Confirmed	AAA	Stb	 
10-Nov-23	Long-Term Local Currency - Issuer Rating	Confirmed	AAA	Stb	 
10-Nov-23	Short-Term Foreign Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	 
10-Nov-23	Short-Term Local Currency - Issuer Rating	Confirmed	R-1 (high)	Stb	 

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