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**Statement by Mr. Pösö on Luxembourg
(Preliminary)
Executive Board Meeting
May 14, 2021**

We thank Staff for their clear and insightful report in the context of Luxembourg's Article IV consultation. We also thank Mr. Dresse and Mr. Scholer for their informative Buff statement. We commend the national and EU authorities' resolve to fight the health, social and economic consequences of the ongoing pandemic.

Following years of strong growth, Luxembourg has managed the economic effects of the pandemic relatively well thanks to vigorous domestic demand, the structure of its economy with a low share of contact-intensive sectors, and the unprecedented domestic and global policy response. Owing to a persistently prudent fiscal stance, the government has made good use of the ample fiscal space to articulate a decisive policy response, which has been crucial to cushion the impact of the pandemic on the economy. Going forward, support should be reoriented to sustain the green and digital transitions, while addressing existing vulnerabilities. We broadly agree with the main conclusions and thrust of the report but would like to elaborate on the following points for emphasis.

Macroeconomic developments

We agree with Staff's favorable growth outlook for Luxembourg and risk assessment, which remains tilted to the downside and still subject to considerable uncertainty. The negative impact of the COVID-19 pandemic on the economy has been milder than initially foreseen, and one of the smallest in the euro area. Luxembourg already recovered to its pre-pandemic level of output at the end of last year, and although the evolution of the pandemic continues to be a relevant risk, we agree with the fast recovery projected from 2021 onwards, driven by domestic demand. We expect however a somewhat slower pickup in external trade, in line with the EU recovery. Regarding inflation, we share staff's view of a pickup in

inflation in 2021, which should then stabilize just below 2% over the medium term. Despite Luxembourg's favorable growth outlook based on its solid fundamentals, some vulnerabilities remain and others have built up. These relate mainly to its comparatively high sectoral concentration and openness, with a strong reliance on the financial sector and related services exports, which the Authorities should continue to address through their diversification efforts.

Fiscal Policy

Given the ample fiscal space available, policies should remain supportive until the recovery is firmly established, and then focus on supporting a structural transformation of the economy. As pandemic-related measures are unwound, we agree that fiscal support should pivot towards facilitating the digitalization of the economy while pursuing climate commitments and closing infrastructure gaps, in line with the ambitious public investment agenda pursued by Authorities, also making a full use of NextGenerationEU Funds. We are somewhat more optimistic than Staff about the fiscal outcome for 2021, although we recognize the potential impact of the ongoing global tax reforms on Luxembourg's tax revenues. We welcome the clear analysis on the taxation of Multinational Enterprises and agree that Authorities have made numerous efforts to be aligned with international standards and best practices, as noted in Annex VI. We also highlight the need for transparency and fairness in tax policy, noting that the positive elements of fighting aggressive tax planning could be given more prominence. In our view, a major challenge for fiscal policy is a pension reform that ensures the long-term sustainability of public finances and preserves fairness across generations. We agree that the current framework governing public investment could be strengthened by improving spending efficiency and transparency.

Financial Sector Policies

Despite its resilience during the crisis, we broadly agree with the risks to Luxembourg's highly interconnected financial sector, including in the investment-fund industry, which stress the need to extend macroprudential surveillance and regulation. Solvency pressures in the non-financial and household sectors could intensify, with knock-on effects on the bank balance sheets. Moreover, a potential sharp tightening of global financial conditions may also negatively affect the stability of Luxembourg's highly interconnected financial sector, also given its large investment fund industry. While we agree that the latter has weathered the crisis well, also due to decisive global policy actions and robust oversight, the potential repricing of risk premia may still pose risks to financial stability going forward. These risks underscore the need to actively support international initiatives for a macroprudential toolkit for investment funds. Ongoing international initiatives on tax harmonization and transparency regulations may weaken growth prospects for the financial

sector and affect employment and fiscal revenues. To strengthen its position as an international financial center, Luxembourg needs to speed up the implementation of a secure connectivity network, as well as the strategy for sustainable finance. In the short term, the financial sector needs to continue ensuring financial access to firms, mainly SMEs, especially when support measures are phased out, while developing new instruments in support of private investment to foster the green and digital transition. We also welcome the call for continued monitoring and mitigation of money laundering and terrorism financing risks, and for the framework to be further strengthened where necessary.

We agree that the continued rise in residential real estate prices and private indebtedness, particularly for vulnerable household segments, warrants continued monitoring, but do not see the need for an increase in the countercyclical capital buffer at this stage. Household indebtedness has continued to increase in parallel with rising house prices, with additional risks emerging from the pandemic regarding the solvency of more vulnerable households. In this context we welcome the introduction of differentiated Loan-to-Value limits, which should enhance the debt sustainability of new mortgages. We would also like to stress the importance of an impact evaluation before considering further policy action, given the uncertainty about the current position in the credit cycle and diverging credit dynamics between firms and households. Depending on future credit dynamics, more targeted measures such as borrower-based measures might be better placed to address these developments than increasing the countercyclical capital buffer. This notwithstanding, we agree that close and continuous monitoring of credit dynamics remains warranted.

Structural Policies

Tackling increasing wealth and income inequality requires actions to improve housing affordability, education and training and wage bargaining mechanisms to facilitate reskilling and upskilling and facilitate sectoral reallocation. One of the main sources of inequality in Luxembourg is wealth, 85% of which is tied up in housing. The chronic under-supply of housing continues to drive up prices and is one of the main barriers to investment and growth. Against this backdrop, the reform of the Housing Pact should strengthen the public sector's capacity to increase the stock of public housing and affordable rental housing. Concerning income inequality, improving vocational education and training will be key to improve upskilling and reskilling programs at all levels of qualification, in particular in activities with the highest growth potential. Making use of digital learning environments may offer the opportunity to scale-up trainings. At the same time, the report could elaborate more on the key role of the automatic wage indexation scheme, which is a key reason for the weak link between wage and productivity growth, and might limit the adjustment capacity of the economy and prevent a swift reallocation of labor.