FOR INFORMATION

FO/DIS/21/69

May 12, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Luxembourg—Statement by the European Central Bank Representative**

Board Action:	Executive Directors' **information**
Additional Information:	For the Executive Board discussion on Luxembourg to be held on Friday, May 14, 2021.

May 12, 2021

Statement by Rasmus Rueffer (ECB representative) and Kleopatra Nikolaou on Luxembourg – 2021 Article IV Consultation
(Preliminary)

IMF Executive Board Meeting

May 14, 2021

We thank Mr. Dresse and Mr. Scholer for their informative Buff statement and Staff for their report. We associate ourselves with the Statement of Mr Pösö and would like to highlight the following issues:

We broadly agree with Staff's favorable growth outlook for Luxembourg, although uncertainty remains considerable and risks remain tilted to the downside. The negative impact of the COVID-19 pandemic on the economy has been one of the smallest in the euro area and milder than initially foreseen. With growth having recovered to its pre-pandemic level of output at the end of last year, we agree with the fast recovery projected from 2021 onwards, driven by domestic demand. We also agree with Staff on a pick-up in inflation in 2021, before stabilising just below 2% over the medium term. Risks surrounding the outlook should be seen in the context of existing vulnerabilities and relate to its comparatively high sectoral concentration, a rather rigid labor market, and high, increasing real estate prices amid high private sector indebtedness. Ageing demographics (which impact the labor force) could be stressed more as an important risk for the macroeconomic outlook over the medium- and long-term. At the same time, risks related to the evolution of the pandemic, as explained by Staff, remain highly relevant.

We broadly agree with the risks identified for Luxembourg's highly interconnected financial sector. Solvency pressures in the non-financial sector could intensify in case of prematurely ended support measures or a delayed recovery, while a sustained economic slowdown could weigh on the labor force and impact negatively households' debt repayment capacity, with knock-on effects on the balance sheets of banks. Moreover, a potential sharp tightening of global financial conditions may also negatively affect the stability of Luxembourg's highly interconnected financial sector, not least due to its large investment fund industry.

We agree with Staff that the pandemic crisis illustrated the growing vulnerabilities of the non-bank financial sector, notably the investment fund sector, stressing the need to extend the macroprudential surveillance and regulation. Vulnerabilities of Luxembourg's large and complex financial system result from global as well as domestic interconnections via its large investment fund industry. While we agree that the latter weathered the crisis and the March 2020 turmoil 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 and the March 2020 experience underscore the need to actively support international initiatives for a macroprudential toolkit for investment funds.

We share Staff's concerns regarding risks from the continued rise in house prices as well as high indebtedness, particularly for vulnerable private household segments. We see additional risks emerging from the pandemic regarding the solvency of more vulnerable households. In this context we welcome the introduction of differentiated LTV limits, which should enhance the debt sustainability of new mortgages and we agree with the need for continued monitoring. At the same time, we would like to also stress the importance of an impact evaluation once first data will be available in the course of the second half of the year before considering further policy action.

Given the uncertainty on the current position in the credit cycle and indications for diverging trends in credit dynamics for firms and mortgages, we do not view an increase in the countercyclical capital buffer warranted at this stage. Depending on the nature of future credit dynamics, more targeted measures such as borrower-based measures might be better placed to address these developments. This notwithstanding, we agree that close and continuous monitoring of the evolution in credit dynamics remains warranted.

We agree with Staff that fiscal policy should remain supportive until the recovery is firmly established. Making good use of the accumulated fiscal space, the government's response to the pandemic was decisive and helped to cushion the economy and limit the impact of the pandemic. As pandemic-related measures are unwound, drawing on the ample fiscal space, we agree with Staff that fiscal support should pivot towards facilitating the digitalization of the economy while pursuing climate commitments and closing infrastructure gaps. It would be useful if Staff could provide additional information regarding the general conceptual underpinnings for the pre-COVID-19 level of output as a benchmark to determine the timing for the unwinding of fiscal support. In the case of Luxembourg, a return to the pre-COVID-19 level of real GDP as a benchmark for starting an unwinding fiscal support would appear overly strict in the case of Luxembourg which has built up fiscal buffers in the past. Luxembourg could make use of the fiscal leeway provided for under the SGP's activated general escape clause (GEC) for targeted and growth-enhancing measures and follow the Council's fiscal adjustment requirements once the GEC becomes deactivated.