FOR INFORMATION

FO/DIS/23/51

May 16, 2023

To: Members of the Executive Board

From: The Acting 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 Wednesday, May 17, 2023.

15 May 2023

Statement by Rasmus Rueffer (ECB Representative) and Maddalena Perretti (Advisor) on Luxembourg – 2023 Article IV Consultation

IMF Executive Board Meeting

17 May 2023

We would like to thank Mr. Dresse and Mr. Scholer for the informative Buff statement, and Staff for their balanced Report. We broadly agree with Staff and share many of the main findings. We associate ourselves with the statement of Mr. Vasiliauskas and would also like to highlight the following items for emphasis.

We agree with staff that lower global growth is likely to limit the projected GDP growth in 2023, at the same time we also agree with the national authorities that GDP growth can rebound faster to potential output than what has been projected by staff. The ECB staff projections from the March 2023 Macroeconomic Projections Exercise forecast real GDP growth to be at 1.5% in 2023, and to increase at a faster pace in the following years at 2.6% in 2024 and 2.5% in 2025. The Luxembourgish economy has remained relatively resilient to the developments in global growth in recent years, leading ECB staff to be somewhat more optimistic than IMF staff. Relatedly, we wonder whether there may be scope for slightly higher potential output growth in the medium term.

We broadly agree that the risks surrounding the projected path for economic activity are tilted to the downside. The risks to the economic outlook flagged by Staff continue to be relevant. Luxembourg remains very reliant on both the financial and external sectors of the economy, coupled with certain labour market rigidities as well as high and increasing real estate prices amid high private sector indebtedness. We see similar medium- and long-term risks as Staff, including climate risks and those related to an ageing of the population.

We also broadly agree with Staff views on fiscal issues.

We broadly agree with the risks identified for Luxembourg's highly interconnected financial sector regarding leverage and liquidity, especially following the tightening of global financial conditions and the recent financial market stress. The significant banks-funds interlinkages pose contagion risks. These are, however, mitigated by large liquidity and capital buffers in the banking sector.

We broadly agree with Staff's view that vulnerabilities increased in the real estate sector and higher inflation and borrowing costs are likely to increase credit risk. Housing price growth has started to moderate, and Staff projects that a sharp correction in real estate prices is unlikely in the short term. Still, our assessment is that the high level of household indebtedness and sustained property price growth in recent years mark the main cyclical vulnerabilities in Luxembourg and warrants continued close monitoring.

We share Staff's view that macroprudential policy could be adjusted to increase banks' resilience and avoid the build-up of vulnerabilities, especially in the real estate sector. Staff suggests considering complementing the available measures with income-based limits (e.g. Debt-Service-To-Income, Debt-To-Income limits). In addition, Staff argue that targeted capital-based measures could be warranted to enhance loss absorption capacity in the case of a severe shock to real estate. This in line with the ECB staff assessment on real estate risks and possible policy actions, although income-based limits' calibration should be carefully considered in the current environment. In addition, we agree with Staff that the LTV limit should not be loosened if the credit cycle deteriorates considerably. Instead, the authorities could consider relaxing the CCyB.

We welcome the focus of the report on the wage indexation scheme, and we broadly agree with the policy recommendation to link wage indexation to core inflation or, alternatively, to introduce a progressive scheme based on competitiveness indicators. The effects of the current automatic wage indexation system have led to rapidly increasing unit labour costs and are translated into a loss of cost competitiveness. This rigidity in the labour market might also limit the adjustment capacity of the economy and prevent a swift reallocation of labour.

Finally, we broadly agree with the assessment on the need to increase labour force participation of female and elderly workers, and note the structural policies undertaken by the government towards the accomplishment of these goals. The structural policies in place can improve the labour market conditions for vulnerable groups of the population, while also reducing labour shortages and potentially contributing to the sustainability of the pension system. By contrast, we consider that the Staff report could also benefit from a more extended analysis on the employability of young workers.