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Statement by Mr. Rediker and Mr. Meyer on Luxembourg
(Preliminary)
Executive Board Meeting 10/54
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Given its openness, integration, and out-sized financial sector, Luxembourg was directly impacted by the global economic crisis and its economy has faced its sharpest downturn in over 30 years. But it has also fared better than many other European countries and appears to be on track for a clear, if moderate, rebound. Relatively low debt and prudent fiscal management provided the authorities with the necessary fiscal space to take appropriate stimulus measures and address some financial sector risks. Risks remain, however, and we concur with the staff's assessment and recommendations to tackle near- and medium-term vulnerabilities related to the financial sector and fiscal management.

Financial Sector

Luxembourg has one of the largest financial sectors in the world relative to GDP and, given its prominent role in wholesale finance and group risk management, contagion risks remain quite large. The authorities have taken a number of steps, in concert with European regulators and supervisors, to address some of these risks. Improved supervisory coordination is a welcome step. But the enormous inter-group and regional exposures clearly highlight that much more needs to be done to deal with liquidity risk management, leverage, and risks related to cross-border bank failure and resolution. Burden-sharing in the bank failures of 2008/09 highlighted were handled on an ad hoc basis and Luxembourg would clearly benefit from a clearer framework, especially one with benchmarks to encourage earlier intervention. We support the staff's recommendation and urge the authorities to work with their European counterparts to address rapidly the outstanding resolution and burden-sharing issues. Close and clear monitoring of financial group vulnerabilities with home country supervisors is vital. We would welcome some further elaboration on how this is handled with respect to groups with known weaknesses, such as the German Landesbanken noted in Box 2 which hold about 12 percent of system assets, over 250 percent of GDP. As other countries have demonstrated, the authorities need not wait for the final decisions on minimum capital and liquidity requirements before addressing problems in key banks. Indeed, tackling these issues now will address risks now and help ease the transition to the new rules.

While higher levels of deposit insurance are reassuring, we urge the authorities to approve legislation to move speedily to an *ex ante* funded deposit insurance scheme; events from 2008-09 serve as a reminder of the urgency. In discussing risks to the financial sector, the staff note that banks in Luxembourg face downside risks from sovereign debt holdings. We would welcome a staff update and comments on these risks, especially in light of recent developments in Europe. We also wonder if the supervisors or authorities have taken steps to address directly these risks with banks. The stress testing results noted in the buff provide comfort that these issues are manageable. However, publishing the assumptions and results at the bank level could provide helpful reassurance to markets as well.

Messrs. Prader and Mevis' buff underscores that the authorities are taking steps to address the FATF recommendations noted in section VIII of the informational annex. We urge them to fully address all outstanding issues in a timely manner. We also note the discussion on the changing regime for taxation and bank secrecy. Luxembourg faces the additional challenge of adapting to this on top of the deleveraging of the financial sector and need to address tighter regulation and supervision. We note the authorities' desire to adopt a moderate and gradual approach to implementing new rules and requirements. But, given the scale of the financial sector and potential risks, we wonder if a more forthright approach to financial sector oversight might be more prudent.

Competitiveness

We appreciate the staff's analysis and discussion of competitiveness in Luxembourg. While we note that competitiveness has remained among the highest in Europe, the analysis in Box 1 raises questions about how much one can rely on this assessment, noting the skewed results created by the very large role of the financial sector. We welcome the attention that Messrs. Prader and Mevis place on addressing competitiveness and, in particular, the automatic indexation of wages. This is clearly a damper on efficiency and we wonder why the authorities are focused more on adjustments than on comprehensive reform or abolishment.

Fiscal Challenges

The staff clearly highlight the near- and medium-term fiscal challenges and the forecast is sobering. We are reassured, however, by Luxembourg's solid track record of prudent fiscal management. Addressing comprehensive pension reform is clearly the most pressing issue to address fiscal pressures and competitiveness. We urge the authorities to use the current environment to jump start such reforms. But, with the looming drain on public finances if reforms are not implemented rapidly, we wonder if the return to a fiscal balance by 2014, as envisioned in Luxembourg's Stability and Growth Program, will be sufficient. It seems Luxembourg may need to actually run surpluses in order to address future fiscal demands.