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**Statement by Mr. Daïri and Mr. Kwakye on Luxembourg
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010**

As an “exceptionally open economy” and an “internationally-integrated financial sector”, Luxembourg has been severely hit by the global crisis, experiencing a substantial decline in real GDP, a weakening of the labor market, and a sharp decline in the balance and off-balance sheets of the important banking sector, and in the assets managed by the large investment fund industry. The authorities’ substantial and decisive policy response to strengthen confidence in the financial sector and to provide support to the economy, aided by an initial position of fiscal strength, has mitigated the impact of the crisis, and it is encouraging to note that financial conditions have stabilized and the economy is recovering, and is expected to strengthen further next year. We are also pleased to note from Mr. Prader and Mr. Mevis’ helpful statement that, reflecting the extension of partial employment schemes, the loss in employment in the industrial sector has been moderate. Going forward, the prudential and supervisory framework needs to be strengthened, drawing lessons from the crisis, while timely fiscal consolidation will be necessary to bring the rising deficit and public debt under control.

Luxembourg’s highly-open and internationally-integrated financial sector has come under considerable strain during the global crisis. While, as Mr. Prader and Mr. Mevis indicate, the sector has somewhat stabilized, vulnerabilities remain, especially relating to liquidity and credit risks. We note that the authorities fully recognize the risks involved, including from the sovereign risk in Europe, and have taken steps to further strengthen the supervisory and regulatory framework. Particularly noteworthy is the heightened cooperation between the supervisory authority and the central bank. Mr. Prader and Mr. Mevis elaborate on mechanisms put in place for banking sector-wide and bank-specific interventions to ensure adherence to prudential requirements. The large presence of foreign banks and their cross-border nature highlight the importance of close cooperation with home supervisors to limit potential spillover effects. It is pleasing to note that past collaboration with neighboring countries to deal with troubled banks proved effective in containing potential. The authorities’ commitment to international cooperation and supervisory coordination, including regarding compliance with requirements of the Committee of European Banking Supervisors and Basel Committee on Banking Supervision, is therefore well placed. The upcoming FSAP

Update should inform the authorities in their efforts to further strengthen financial stability.

While continued fiscal stimulus is warranted in the near term in view of the still weak recovery, Mr. Prader and Mr. Mevis underscore the authorities' commitment to post-stimulus fiscal consolidation. This will return fiscal policy to a path of sustainability and in line with the Maastricht criterion. As they indicate, fiscal consolidation is to be achieved through the social consensus-based policy making process in the context of the authorities' Stability and Growth Program. We note the package of revenue and expenditure measures planned to this end, with spending cuts appropriately assuming a dominant role. The more forward-looking budgetary framework, which the authorities intend to adopt, represents an appropriate vehicle for expenditure prioritization and achievement of the balanced budget target by 2014.

The social benefits system needs to be reformed to rein in its disproportionate and rising share in the budget. In this connection, we welcome the authorities' intent to deal with the challenges associated with population ageing, where Luxembourg appears to have a high burden relative to its EU peers. The on-going tripartite discussions indicated by Mr. Prader and Mr. Mevis represent an appropriate forum for ensuring more sustainable social security and pension systems, learning from other countries' experience.

Safeguarding Luxembourg's productivity and competitiveness, including in the important financial sector, is critical to sustaining the recovery and maintaining the high living standards. As recognized by Mr. Prader and Mr. Mevis, reining in rising unit labor costs is an important component of efforts to this end. Planned reform of the wage and remuneration structure in the public sector is crucial to achieving not only expenditure targets but also improved competitiveness. In particular, it will be important to adjust the automatic wage indexation mechanism to link wage increases more closely to productivity gains. Enhancing competitiveness also calls for improvement in the business environment to support investments in physical and human capital and advanced technology so as to protect Luxembourg's traditional comparative advantage in high value added activities.

Risks to Luxembourg's outlook continue to hinge on the global outlook, given the economy's high reliance on external markets. Market distress relating to European sovereign risk represents a new source of concern. In the circumstances, continued vigilance is pertinent, relying on Luxembourg's traditional strengths while adapting policies promptly to respond to new developments and potential shocks.

We wish the authorities continued success in their endeavors.