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

We thank staff for their clear and concise papers, and Messrs Prader and Mevis for the very useful context provided in their Buff statement.

After a severe shock to Luxembourg's economy, stemming from global financial stresses and the subsequent economic downturn, we are pleased to see that the country has started on a path to recovery. Given continued international weakness that path will clearly be a challenging one, but it is evident that the authorities are keen to address the financial sector risks and structural factors that could harm Luxembourg's growth prospects.

The large and internationally-oriented financial sector is a significant source of both growth and exposure to risk for Luxembourg. In addressing financial sector risk the authorities must thus take account of the sector's importance to the economy, and we feel that they are taking the right approach by seeking to improve risk management and buffers rather than simply limiting size or international exposure.

The policy responses suggested by staff, many of which the authorities are pursuing, involve a good mix of: increasing required buffers against risk; strengthening governance and risk management in institutions; improving information about, and clarifying the status of, institutions' exposures to related parties; and enhancing the authorities' supervisory capacity. The last addresses supervision in both normal times and under stress, through domestic as well as cross-border regulatory arrangements. The measures discussed look likely to limit risk to the economy and to limit fiscal exposure to financial sector troubles. Among recent initiatives, we are pleased to see the use of stress testing and direct follow-up by authorities to require capital add-ons where there is a need.

At the same time, we note staff's comments that international proposals for capital and liquidity regulation could affect the competitiveness of Luxembourg's financial sector, and the authorities' support for international discussion on these matters. *We would be interested in how the authorities plan to adapt these to local conditions – namely to a very open and internationally-focused financial system like Luxembourg's.*

Staff point out that bank subsidiaries in Luxembourg have large exposures to, and have been providing liquidity to, parents abroad. It is important that such subsidiaries cannot be forced to do this at the expense of the subsidiaries' soundness. This in part can be addressed by ensuring that the management of domestic subsidiaries have full discretion to protect the subsidiary's soundness.

While cross-border cooperation among authorities is important, and burden-sharing agreements are an important part of that, the effectiveness of cross-border arrangements requires clear domestic capacity to address budding financial stress. Clear understanding of domestic obligations and powers must inform any cross-border agreements, and it must be recognized that cross-border arrangements cannot always be made binding.

We agree with the assessment of the fiscal outlook that was made at the time of the consultation – notably the appropriateness of maintaining stimulus through 2010 and the need to begin consolidation from 2011. Noting the importance of Europe to Luxembourg's external and financial sectors and the exposure of Luxembourg-based banks to a number of European sovereigns, *we would be interested in an update from staff about whether economic developments in Europe since the consultation have affected the economic outlook and appropriate macro-economic policy for Luxembourg.*

Finally, Staff notes a number of structural and institutional factor to address – such as pension reform and flexibility in wage setting. We agree that these are likely to be important to the economy's long run performance. We are pleased to note that the authorities have many of these issues on their policy agenda. We encourage the authorities to look further, as planned, at the backward-looking wage-indexation mechanism to ensure that it does not inhibit the labour-market flexibility needed to maintain competitiveness. We are pleased to note that there is an open dialogue on this in a tripartite context, and hope that satisfactory progress can be made.