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GRAY/10/1917

May 27, 2010

Statement by Mr. Stein and Mr. von Stenglin on Luxembourg
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010

We thank staff for a thorough and comprehensive report and broadly concur with the assessments and recommendations. We also thank Messrs. Prader and Mevis for their candid and helpful Buff statement.

Luxembourg has been particularly vulnerable to the global financial and economic crisis owing to its large financial sector and its heavy reliance on external markets. Consequently, the country experienced a severe recession in 2009. The ramifications of the extraordinary shock were mitigated, however, by the authorities' swift response to stress in the financial sector, which was closely coordinated with EU partner countries, and by drawing on strong fiscal buffers.

Economic Outlook

Luxembourg's economy is recovering and the outlook has improved, though downside risks remain. The ongoing recovery is driven by returning confidence, financial sector recovery and stronger export demand. However, growth in 2010 is relying to some extent on temporary factors such as the inventory cycle, fiscal stimulus and carry-over effects. Therefore, the recovery is likely to proceed gradually. We share the authorities' view that uncertainty around the outlook remains high, not least due to volatile markets in the context of recent worries about sovereign risk in parts of the euro area. Looking ahead, reducing the reliance on the financial sector and increasing economic diversification could be considered.

Financial Sector

The crisis has been a stark reminder of macro-financial risks stemming from a large financial sector. Therefore, we welcome the authorities' request for a FSAP update. Furthermore, it appears worthwhile to take due account of international regulatory initiatives, to strengthen supervision and the regulatory framework. In this regard, we are reassured by the authorities' intention to implement several regulatory initiatives in areas such as capital requirements, liquidity management and deposit insurance (bearing in mind that these regulatory issues are global in nature). Moreover, we welcome the authorities' strong commitment to cross-border cooperation in financial sector supervision which is essential given the tight linkages to the European banking system. The authorities' intention to fully and promptly implement the recommendations of the FATF evaluation is appreciated.

We encourage the authorities to strengthen and implement formal mechanisms for cross-border bank resolution and burden-sharing, based on the EU framework of financial crisis management. This framework encompasses a Memorandum of Understanding (MoU) on cooperation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union containing common principles, a common framework and common practical guidelines to facilitate the management and resolution of cross-border financial stability issues. At its last meeting on May 18, the ECOFIN has further specified such arrangements, focusing on cross-border stability groups and broad parameters for burden-sharing. As an EU member, Luxembourg will act in compliance with this framework. Moreover, there is the need to enhance cooperation *ex ante*, at the supervision level, with a more formalized framework to exchange data and information between Luxembourg's authorities and the parent banks' supervisors.

Moreover, we would caution against using the term "credit crunch" lightly, even in the softened form in the present context. Disentangling demand-side and supply-side effects of credit aggregates is a complex issue.

Fiscal Policy

We commend the authorities on their timely announcement of fiscal consolidation measures. While some degree of discretionary stimulus was warranted to cushion the downturn, lasting fiscal consolidation should start in 2011. Therefore, the announced consolidation measures, consisting of an increase in revenues and expenditure cuts, are very welcome and appear sufficient to reduce the deficit to below 3% of GDP in 2011. Moreover, we appreciate the announced objective of achieving a balanced budget by 2014. Beyond the focus on near-term consolidation, fiscal sustainability crucially requires an overhaul of the current pension system, given the very high budgetary impact of ageing in Luxembourg (projected to be the strongest in the whole EU), and we welcome the authorities' commitment in this regard.

Structural issues

The crisis of the financial sector provides a welcome opportunity to diversify business activity in Luxembourg. This can be facilitated by focusing investment on research and development and by increasing efforts to educate the workforce. The latter could also help reduce unemployment among residents. In addition, we fully share the staff's assessment that Luxembourg would benefit from eliminating automatic wage indexation over time and welcome the discussions in this regard as announced in Messrs. Prader and Mevis' Buff statement.