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Statement by Mr. Sadun and Ms. Marchettini on Luxembourg
(Preliminary)
Executive Board Meeting 10/54
May 28, 2010

We thank staff for the well-focused report, and Mr. Prader and Mr. Mevis for the useful additional information provided in their Buff statement.

1. Although Luxemburg's core businesses were severely affected by the global financial crisis, the authorities' prompt reaction helped mitigate the effects of the downturn. Exceptional measures were introduced to stabilize the financial sector, while a strong fiscal stimulus was enacted to sustain internal demand. **The economy exited the recession in mid-2009 and leading indicators suggest that the recovery is now underway; however the near-term outlook remains challenging**. As a small open economy overly dependent on the financial sector, Luxembourg is more exposed than other European countries to downside risks if financial turbulences persist.

2. **In the longer term, the structural transformations in the financial market and stricter international regulatory standards may have acute implications on Luxembourg's potential growth and fiscal budget**. The ongoing deleveraging of the financial sector will likely keep economic growth and fiscal revenue below previous trends, while Luxemburg's attractiveness as a financial center may be undermined by efforts to reduce banking secrecy and to harmonize cross-country taxation. The impact of these factors may be mitigated by structural reforms aimed to increase economic diversification, and enhance competitiveness.

Since we broadly share the staff's appraisal and the view expressed by Messrs. Stein and von Stenglin, we limit our comments to a few points.

3. The authorities reacted promptly to the crisis, thus limiting its impact on the economy. **In 2010 a moderately-accommodative fiscal stance remains appropriate to underpin the recovery; however, it is essential that the authorities start preparing for how to exit from the fiscal stimulus.** Even if the economy continues to strengthen, Luxembourg will not be able to meet the goal to balance the budget by 2014, as indicated in the last update of the SGP, without measures to correct the fiscal stance. Furthermore, despite its low debt level, the soundness of the fiscal position is subject to significant downside risks, connected to the over-reliance of the revenue base on the uncertain performance of the financial sector.

4. Looking forward, a number of elements point to a challenging outlook. On the revenue

side, a possible permanent decline in financial sector profitability may have a significant impact on the tax base; on the expenditure side, social security costs are set to rise substantially due to the generosity of the welfare system and adverse demographic trends (Box 3).

5. In this regard, the authorities' firm commitment to fiscal consolidation is particularly welcome. **Although the plan presented by the government is a step in the right direction, further spending cuts are needed to improve the fiscal balance in the long term.** We share staff's view that an early reform of the pension system is the only viable option to ensure the sustainability of the pension system. Finally, the adoption of a multi-year budget framework would also be helpful in enhancing the fiscal performance and controlling current expenditure.

6. The authorities' quick reaction to the market turmoil helped in limiting spillover effects and boosting market confidence in the midst of the crisis. The situation in the local financial market has since stabilized. Capital buffers are high and the NPL ratio is one of the lowest in the EU area. However, **the crisis has highlighted the significant vulnerabilities of the system.** Notably, the financial sector is exposed to: (*i*) a relevant liquidity risk, which is connected to the high prevalence of subsidiaries of foreign groups; (*ii*) a consistent systemic risk, due to the particular structure of Luxembourg's financial system, characterized by intra-bank exposures and linkages between banks and funds; and (*iii*) a non-negligible credit risk, related to the high leverage in the balance sheets.

7. In this respect, we commend the authorities for the reform efforts, aimed to translate in legislation the recommendations of the European Commission and the IMF staff, including those specified in the FATF's recent evaluation. **We stress the importance of enhancing the supervision and the analysis of risks at the group level in the case of cross-border institutions.** *In this respect, the risk stemming from the current tensions in the sovereign market should be evaluated, considering not only the direct exposure of local-based banks (as in the footnote 4) but also the overall exposure at the group level. Could staff provide an estimation of the exposure at this level?* Indeed, the example set by Dexia and Fortis has shown that problems in the parent banks may have a strong impact on Luxembourg's subsidiaries and fiscal position, even if the subsidiaries are sound and liquid. As highlighted by Mr. Stein and Mr. von Stenglin, although a formalized framework on bank resolution and burden-sharing already exists at the EU level, it will be essential to enhance international coordination *ex ante*, at the supervisory level, in the case of cross-border institutions. Accordingly, we believe that the current voluntary cooperation between Luxembourg's government and the parent banks' supervisors to exchange data and information should shift toward a more formalized framework. *Could staff inform the Board if there is any progress on this subject?* Finally, the request of an update of the 2002 FSAP exercise, expected to take place in the second half of 2010, is a welcome step.

8. Luxembourg's banking system is undergoing major structural changes. Pressures to comply with stricter international tax and regulatory standards will undermine the traditional attractiveness of Luxembourg's banking system, and will put the financial institutions under considerable pressures. **Those shocks may have a significant impact on the country's potential growth (see ¶ 38). The risks could be mitigated if the authorities seize the opportunity to introduce reforms aimed to enhance Grand**

Duchy's competitiveness. Inparticular, the automatic backward looking indexation mechanism should be substituted witha system of wage determination more closely linked to productivity.