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AGENDA

SM/85/152

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INFORMATION

May 24, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Luxembourg - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Luxembourg, which is tentatively scheduled for discussion on Monday, June 17, 1985.

Mr. Riechel (ext. 572979) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

LUXEMBOURG

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Article IV Consultation with Luxembourg

Approved by L. A. Whittome and J. T. Boorman

May 23, 1985

Article IV consultation discussions were held in Luxembourg from April 22 to 29, 1985. The staff team consisted of Messrs. P. Dhonte, K. W. Riechel (both EUR), Mr. R. Ley (Paris Office), and Miss S. Durand-Jansiac (secretary-EUR). The mission met with the Prime Minister and Finance Minister, Mr. Santer; the Director General of the Luxembourg Monetary Institute, Mr. Jaans; and officials of the Administration, and the Luxembourg Monetary Institute. The Executive Director for Luxembourg, Mr. de Groote and his Assistant, Mr. Kolb, attended the meetings as observers. The previous staff report (SM/83/264, 12/28/83) was discussed by the Executive Board (EBM/84/10) on January 20, 1984. Luxembourg has accepted the obligations of Article VIII, Sections 2, 3 and 4 of the Fund's Articles of Agreement as from February 15, 1961.

I. Background

The report on the 1983 consultations with Luxembourg recalled that over a period of years the Luxembourg economy had been affected by the decline in the steel sector. The related drop in income and employment had been compensated by the growth of other activities, notably international banking. The report also noted that a July 1983 law (the "Program for a Restructuring of the Steel Sector and the Maintenance of Competitiveness") had provided for temporary increases in taxation to finance the accelerated modernization and restructuring of the steel sector as well as related social transfers, and that a partial suspension of wage indexation was in effect to improve the economy's competitiveness.

In their discussion, Executive Directors commended the Luxembourg authorities for their medium-term emphasis in policy formulation and for avoiding the emergence of large and persistent fiscal deficits. They noted however that the ongoing structural adjustment would demand continued wage moderation and that the emphasis of fiscal policy should shift toward containing the growth in entitlements.

After an average annual growth of just over 1 percent in 1980-83, real GDP is estimated to have risen by about 2 1/2 percent in 1984. 1/ This improvement was for the most part the result of the strengthening of the international steel market. Domestic output and exports of steel increased by close to 20 percent in 1984, contributing almost 2 percentage points to GDP growth. By contrast, domestic demand remained subdued owing notably to restraint in public consumption and to a renewed fall in construction activity. Despite continued labor shedding in the steel sector, employment edged up and the rate of unemployment, at 1.7 percent of the labor force, remained the lowest of the EC countries. Available data on external transactions indicate that steel exports contributed to a further strengthening of Luxembourg's current account position to a surplus of about 10 percent of GDP.

The rate of increase of the consumer price index slowed from 8.7 percent in 1983 to 5.6 percent in 1984. In part, this deceleration reflected a change in the calculation of the index to take account of subsidization of heating fuel prices. However, there was apparently also a slowing in the underlying inflation trend. 2/ In keeping with the authorities' stated policy of wage restraint, the partial disindexation of wages and salaries was continued in 1984 and a single step adjustment of 2.5 percent was made in September to compensate in part for cost of living increases. However, other components of compensation remained free, and real wages in industry, led by a 6 percent increase in the steel sector, appear to have risen by close to 3 percent in 1984. Nevertheless, given the sharp increase in productivity, unit labor costs are estimated to have dropped by 5 percent. Full indexation of wages in steps of 2 1/2 percentage points and calculated on the basis of a six-month moving average of the consumer price index was resumed from January 1985.

The July 1983 restructuring program provided for Central Government expenditures of Lux F 7.6 billion (3 3/4 percent of GDP) in 1983, and Lux F 2.9 billion (1 1/4 percent of GDP) in 1984, mostly in aid to the steel industry. To finance these outlays, the program phased in tax increases and other revenue measures yielding Lux F 2.3 billion in 1983, Lux F 3.8 billion in 1984, and up to Lux F 5 billion in 1985 and beyond. Fiscal revenues and expenditures other than those related to the restructuring program have been almost in balance over the medium term, although at the cost of a rising pressure of taxes and social security contributions. The two main fiscal developments of 1984 were a decision to grant additional aid of Lux F 9.1 billion, spread over the period 1985-87, to the steel sector; and, the achievement of a surplus of

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1/ Throughout this report, GDP measures refer to the staff's calculations. The staff consider the Luxembourg banking sector as an offshore center and therefore include its local operating expenses and tax payments as part of Luxembourg's GDP and exports (see SM/83/264, 12/28/83).

2/ The CPI has been totally revised beginning in January 1985. Since the calculation of the former index has been discontinued, there will be an uncertainty for some time about the actual rate of inflation.

Lux F 1.8 billion or 0.8 percent of GDP, in the execution of the 1984 budget (Table 1). The central government debt at end-1984 was equivalent to 8 1/2 percent of GDP. The budget for 1985, as amended to provide for Lux F 2.7 billion out of the total of Lux F 9.1 billion in fresh aid to the steel industry, foresees a surplus of about 1/4 percent of GDP.

Monetary policy in Luxembourg is severely circumscribed by the openness of the economy and by the monetary association arrangement under which the Belgian franc is legal tender in Luxembourg and the National Bank of Belgium stands ready to intervene in the exchange markets. Movements in the monetary aggregates are strongly affected by portfolio shifts in response to changes in relative interest rates and are not usually indicative of trends in inflation and activity.

II. Report on the Discussions

At the time of the consultation discussions, there was a sense of tempered relief in Luxembourg that the worst of the steel crisis was over. Structural adjustment in the steel sector was well under way and output growth in the economy had been unexpectedly strong in 1984. Moreover, the 1984 budget had closed with a substantial surplus and this seemed to provide some room for maneuver in fiscal policy. The appropriate use of this leeway was seen as the single most important current issue of economic policy with some arguing that taxes should be reduced immediately, and others that the budgetary reserves of the Government should be replenished to their previous level.

1. Restructuring of the economy

The authorities explained that the main part of the restructuring of the steel industry had now been completed. Within the framework of the law of July 1, 1983 and the steel policy of the European Community, Luxembourg had achieved the targeted reduction in production capacity, while upgrading and reorganizing the remaining facilities. The new production and marketing arrangements between Luxembourg's main steel producer, ARBED, and the Belgian group, Cockerill-Sambre, had been operating successfully, under the surveillance of a coordinating committee representing the interests of the two governments concerned.

To complete the restructuring process, the authorities said that it had become necessary to envisage a further injection of public funds to relieve ARBED of the need to service an excessive debt overhang. Some important reduction in steel producers' debt and interest burden had already been undertaken in 1983 and 1984 within the initial restructuring program. Following extensive consultations with the social partners, the Government decided in October 1984 to extend further aid to the steel industry in an amount of Lux F 9.1 billion, representing about 10 percent of outstanding debt. This second phase of financial restructuring was to

Table 1. Luxembourg: Consolidated Central Government Finances

(In billions of Luxembourg francs and in percent of GDP)

	1980	1981	1982	1983		1984		1985	
	Outcome			Budget	Outcome	Budget	Outcome	Budget	Estimate
Fiscal balance	-2.3	-3.8	-2.7	-9.8	-6.1	-3.3	1.8	0.6	3.2
(In percent of GDP)	(-1.5)	(-2.3)	(-1.5)	(-4.9)	(-3.1)	(-1.5)	(0.8)	(0.3)	(1.4)
Impact of Restructuring Program	--	--	--	-5.3	-5.3	0.9	1.2	0.4	2.2
Fiscal balances excluding Restructuring Program	-2.3	-3.8	-2.7	-4.5	-0.8	-4.2	0.6	0.2	1.0
Debt	10.5	11.4	13.0	16.3	16.3	18.6	18.6	18.6	18.6

Sources: Ministry of Finance, Budget Proposal for 1985; data supplied by the authorities; and staff calculations. For details and explanations see Appendix IV.

be spread over several years, the cost to the 1985 budget being limited to Lux F 2.7 billion. Ongoing consultations were being held with the European Commission to establish the conformity of these measures with the Community Steel Plan.

The staff drew attention to the difficult outlook for the steel industry worldwide, and wondered whether a third round of government assistance to the Luxembourg steel industry might not become necessary in the future. The authorities indicated that they had no illusions about the difficulties facing the steel industry, but they believed that the Luxembourg enterprises would be economically and financially viable once the latest measures had been put in place. They noted that labor productivity in the Luxembourg steel industry was now among the highest in the world. The industry was aware of the need for vigilance in maintaining high standards of equipment modernization and competitiveness and the authorities were confident that this could be achieved without further government assistance of the kind undertaken in recent years.

As steel had declined as a source of income and employment, the banking sector had provided the main source of dynamism in the economy, the authorities observed. But even in banking, it had been necessary to make substantial adaptations in the structure of the sector as external conditions changed. During the 1970s, many foreign banks had come to Luxembourg to launch Eurocurrency operations, and thus the activity of Luxembourg-based banks grew more rapidly than the Eurocurrency market as a whole. But the growth of international wholesale banking had slowed down dramatically in the 1980s in the face of the recession in the industrial countries and the debt problems of many developing countries. It became necessary to find alternative banking activities, and the banks in Luxembourg developed their services to personal investors. The number of banks operating in Luxembourg had grown little over the last five years, but operating profits had continued to rise and employment had increased, attesting to the success of the restructuring in the banking sector.

The staff inquired about the outlook for the banking sector in Luxembourg, given the increasingly competitive environment for international banking as deregulation of the financial markets proceeded in other countries. The authorities considered that the Luxembourg banks were an established presence in the market, particularly for trading in currencies other than the U.S. dollar. Moreover, some of the liberalization measures taken in other countries, such as the abolition of withholding taxes on nonresident bond income, were likely to increase the activity of the Luxembourg banks because they were likely to create additional demand for banking products that they were well-placed to deal in. In the developing market for the ECU, Luxembourg was the largest single source of nonbank deposits (from domestic and external resources). The quotation of securities on the Luxembourg Stock Exchange, and the related services such as that of paying agent had grown strongly. Finally, close client relationships had developed and, together with the increased degree of diversification, these provided an element of stability for the banking sector.

The authorities also explained that they would intensify their efforts to attract new industrial ventures to Luxembourg, as few investment projects were in the pipeline. The current incentives for the establishment of new enterprises--some of which were also available to help existing firms to expand--included interest and investment subsidies, tax credits (including accelerated depreciation allowances), and credit guarantees. Since 1976-77 some 58 industrial enterprises had been created in Luxembourg. They were concentrated in the areas of petrochemicals, aluminum, glass and metal-working and had created more than 3,900 jobs by the end of 1984, of which some 1,600 in the last two years. Further measures being envisaged would promote the establishment of new industries and services particularly in regions identified as structurally weak. Increased investment subsidies, more liberal tax credits and simplified administrative procedures were among the incentives under consideration. The entire package was planned to take effect retroactively on January 1, 1985 and would be implemented as soon as the necessary consultations with the European Community had been completed.

2. Income and employment policies

After a partial suspension over almost three years, full indexation of wages and salaries to the consumer price index resumed effective January 1, 1985. The authorities explained that there had been a feeling that the urgency to control wage costs had declined and that the return to the long tradition of full indexation would be a contribution to the maintenance of social peace. However, mindful of a possible deterioration in the economic situation and in international competitiveness, they had agreed with the social partners on a system of safeguards which would permit a renewed partial suspension or modification of wage indexation, should the need arise. The decision would have to be made by a tripartite commission which consisted of the social partners and representatives of the Government. While the authorities accepted that indexation implied certain rigidities in the labor markets, they also felt that there remained sufficient scope for income differentiation in the form of wage drift of various sorts. Moreover, a basic equality of income adjustments was warranted for reasons of equity and solidarity. The authorities also explained that the reintroduction of full indexation was unlikely to have an important effect on basic wage costs in 1985 given the new modalities of the index linking mechanism and given also the slowing of inflation. It was likely that only one index adjustment of 2 1/2 percent would take place in July/August 1985. The return to the system of full indexation provided for no catching-up on income losses during the period of partial disindexation. However, the steel workers had demanded a catching-up which was presently under negotiation.

The staff observed that recent wage developments indicated significant real increases in several sectors, and warned of the risk of a loss of competitiveness. As mentioned above, it notably appeared that real hourly wages in the steel sector had risen by as much as 6 percent in 1984. The authorities observed that the very sharp increase in productivity in 1983-84 had nevertheless reduced unit labor costs in industry quite significantly. While a leveling-off of productivity growth had to be expected in 1985, international cost competitiveness was likely to remain high. The staff, however, warned that the gains in productivity of 1984 were in part cyclical and did not provide adequate guidance for future wage increases.

The authorities expressed concern about unemployment, although the unemployment rate, at less than 2 percent, was very low by international standards (Chart 1). Of particular concern was that 50 percent of the unemployed were under 25 years of age. A number of schemes for the reabsorption of the unemployed existed for young workers as well as others. Many of these schemes involved retraining, which was seen as important in view of the structural adjustment needed in the economy.

3. Fiscal policy 1/

The authorities stated that the need to restructure the economy and especially the steel sector continued to command a high priority in the design of fiscal policy. Considerable resources would still have to be mobilized for this task. Moreover, uncertainties remained with respect to international and domestic economic developments. The Government was therefore decided to pursue its policy of cautious fiscal management. This resolve had not been weakened by the unexpectedly favorable outcome of the public finances in 1984. While actual expenditure had developed much in line with budgeted expenditure, revenues had, as often in the past, again exceeded projections by a considerable margin (Chart 2).

The authorities indicated that the budget for 1985 had again limited the growth of expenditures other than those under the restructuring program to the anticipated growth of nominal income. On the revenue side, it had been decided to keep the special tax measures of the restructuring program in place. However, it had also been decided to index tax schedules, a measure which would reduce the tax burden by some Lux F 1 billion per annum. The 1985 budget projected that this combination of expenditure and revenue policy would result in an overall surplus of Lux F 0.6 billion, after inclusion of the payment of the first tranche of Lux F 2.7 billion of the second steel aid package.

1/ The national presentation of the Government's finances includes borrowing and debt redemption as revenue and expenditure items. Moreover, the authorities separate the financial implications of the restructuring program of July 1983 from the normal budgetary operations. Since 1983, they distinguish a "structural budget," which excludes these implications, from a "conjunctural" budget, which includes them. Finally, the operations of a great number of special government funds (Fonds de l'Etat) which are funded primarily by current and capital transfers from the Central Government, are kept outside the budget (except for their transfer receipts). Unless otherwise specified, the staff have treated the government finances on a consolidated basis and excluding debt operations (Table 1).

Beyond 1985, the authorities expected to enjoy some room for maneuver in the design of their fiscal policies as the yield of the special tax measures of July 1983 was likely to exceed their aid commitments to the steel sector. They intended to retain the increases in indirect taxes introduced in 1983. The main direct taxes would be reduced by an equivalent amount, but gradually, so as to reconstitute the budgetary reserves. Caution with respect to the termination of the special tax measures of 1983 was also warranted because of increased VAT transfers to the EC. Finally, the authorities intended to introduce new expenditure programs, including higher transfers to the investment funds, a minimum income guarantee to households, and increased investment support to enterprises; to make room for these plans, the preparation of the 1986 budget imposed strict guidelines for expenditure under existing programs.

As regards the operations of the social security funds, the authorities indicated that they had taken steps to keep the health funds in balance by controlling costs and raising contributions. For the pension funds--which would temporarily benefit from favorable demographic conditions--the main development had been the unification of the various pension schemes into one risk-sharing system and the move from a state-guarantee system to a state-contribution system, under which the Central Government would in future cover one third of the costs. This change in the system was likely to raise costs to the budget by roughly Lux F 200-300 million per annum.

4. Banking supervision and monetary policy

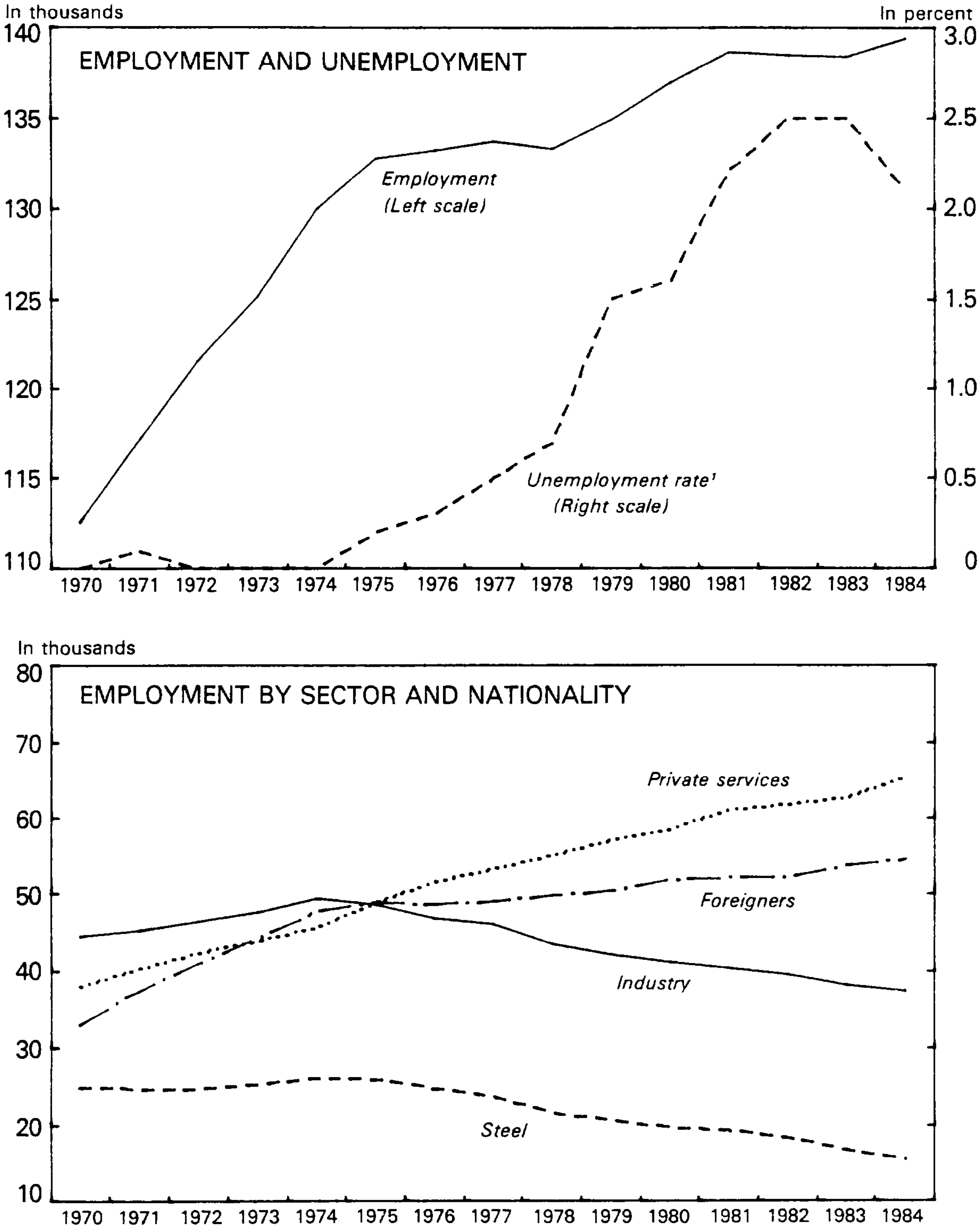
The authorities reported that the Luxembourg Monetary Institute had recently introduced a number of new prudential regulations concerning the activities of banks. In January 1985, it had issued a formal directive requiring the banks to reduce their exposure to any single debtor, or group of economically-linked debtors, to a maximum of 30 percent of the banks' own funds. Banks were given three years, until December 31, 1987, to conform to an interim exposure limit of 50 percent, and a further two years until December 31, 1989, to comply with the limit of 30 percent. The new requirement would not apply to loans to other banks or to official borrowers in industrial countries. Foreign bank subsidiaries could be exempted from the new rule if their parent bank abroad was considered to be adequately supervised on a consolidated basis. The authorities commented that the new requirement was directed as much at the risk of excessive bank exposure through lending to individual enterprises in Luxembourg as it was to international credit risks of private borrowers. They considered that the shift to a more formal approach to bank supervision was appropriate and in conformity with international obligations. It was not to be seen as a disincentive to the banks. In fact, the banks had already been making the necessary adjustments in their portfolios, as the firming of surveillance in Luxembourg coincided with comparable changes in other financial centers and in the home countries of foreign banks.

In conformity with an EC Directive of 1983, a new law would establish the principle of consolidated supervision for Luxembourg banks with branches established abroad. This would complement the legislation

CHART 1

LUXEMBOURG

LABOR MARKET DEVELOPMENTS



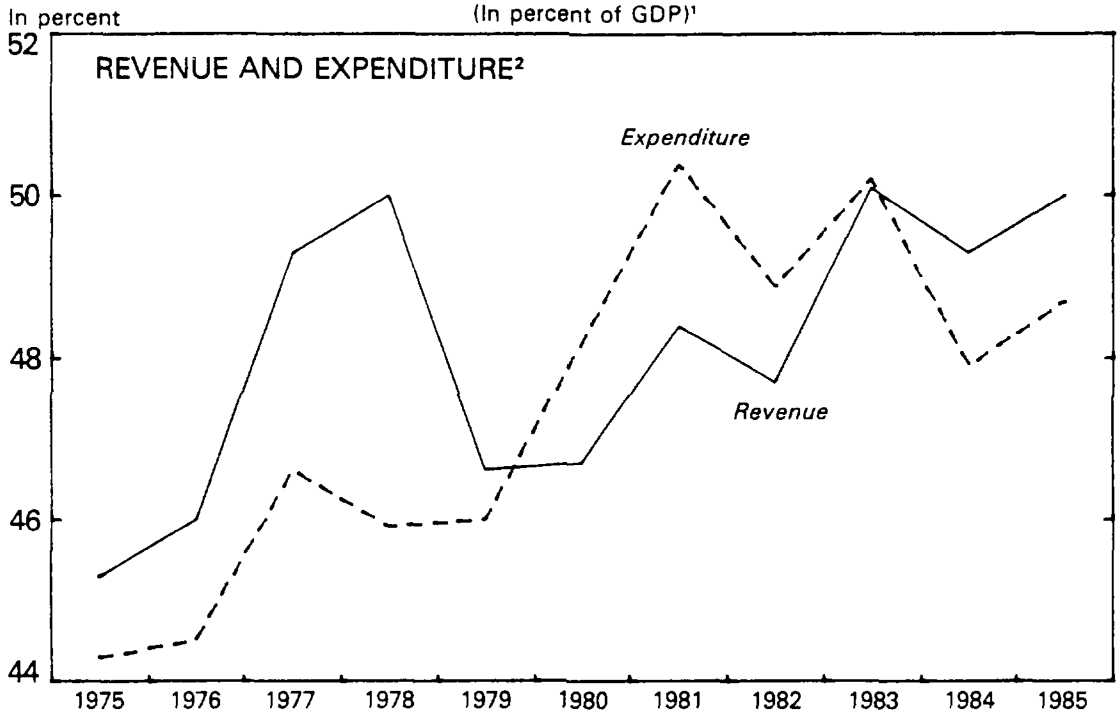
Sources: STATEC, *Annuaire Statistique;* and data provided by the authorities.
[1] Including workers in the *division anticrise sidérurgie* (DAC).

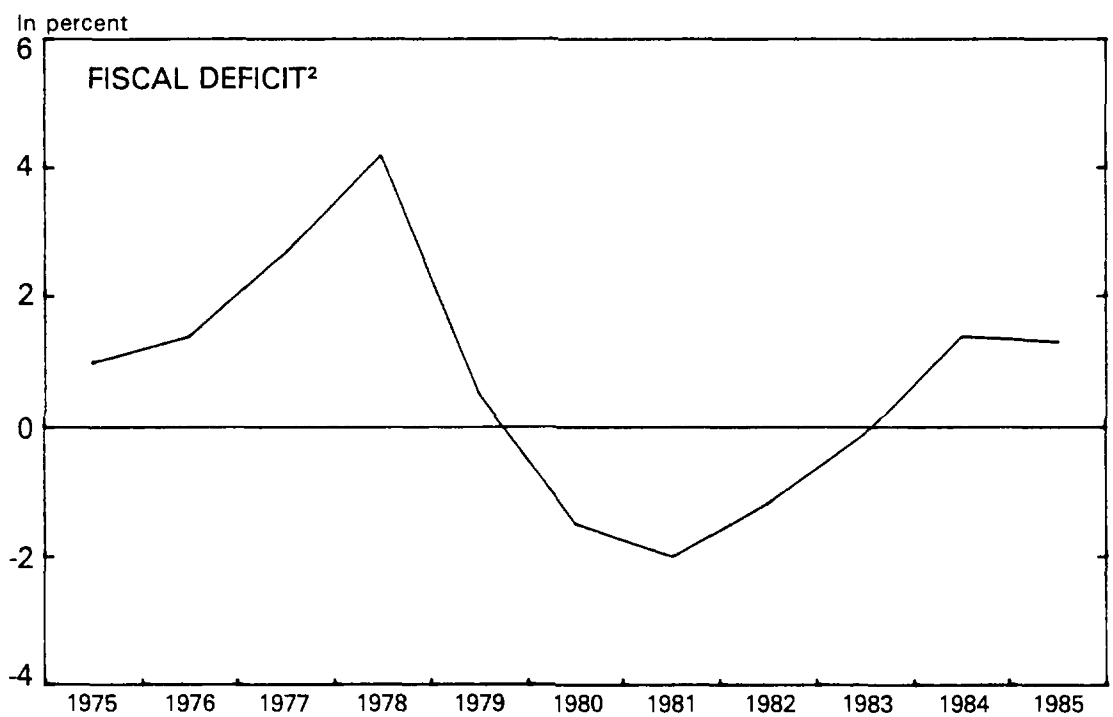
CHART 2

LUXEMBOURG

FISCAL DEVELOPMENTS

(In percent of GDP)[1]





Source: European Communities, *Annual Economic Report;* and staff calculations.
[1]GDP as calculated by the staff.
[2]General government.

already in place since 1981 under which the Luxembourg authorities cooperate with the supervisory authorities of other countries that supervise their banks on a consolidated basis.

The staff representatives observed that risk provisioning by the banks had been running at a very high level (more than 70 percent of operating profits in 1981-83) and inquired whether this high rate of provisioning would remain necessary in the future. The authorities drew attention to the favorable concentration of lending by Luxembourg banks to Western Europe and North America, which was much higher than for the Euromarket as a whole. While exposure to more problematic regions was still considerable, there appeared to be no excessive risks. The rate of provisioning remained a decision of individual banks and it was therefore difficult to predict future developments. But this was not a major concern. Tax revenue from the banks was being approximately maintained in absolute terms.

In view of the openness of the Luxembourg economy and the monetary association agreement with Belgium, the authorities did not consider that they could exercise any effective control over the money supply. Data on the monetary aggregates were considered to be indicative mainly of changes in the liquidity preferences of an increasingly sophisticated public whose investment portfolio was constantly adjusting to changing interest rates and the perceived exchange risk of holding alternative foreign currencies. In recent months, substantial investments had been made in the share market following the entry into force of a new law providing generous tax incentives for equity investments by individuals. Another important development had been the gradual shrinking of the interest differential between government bond yields and rates on comparable securities. The authorities explained that this had come about as the volume of government issues had, during the recent period of additional debt financing for the restructuring of the steel sector, risen above the level at which they could be placed entirely with captive investors such as pension funds and insurance companies. To attract non-captive investors, rates had to be raised to approach market rates. There had been no change however in the mortgage or passbook interest rates both of which were in effect determined by the State Savings Bank. The commercial banks played a minor role in the provision of mortgage finance and relied on their international operations for their profitability.

5. External developments and policies

The authorities expressed their satisfaction about the favorable development of the external balance in 1984, and in particular about the sharp increase in the volume of exports, which had not been limited to the steel sector. Moreover, after a number of years of deteriorating terms of trade, a significant improvement had been registered in 1984 mainly as a result of the rise in steel prices. Developments in 1985 were viewed optimistically. The authorities were also pleased with the recent stability of the exchange rate (Chart 3) and especially with the strengthening of the Luxembourg/Belgian franc within the European Monetary

System (EMS), which they attributed to the firming of financial policies in Belgium and the general improvement in the economies of both countries. 1/ The authorities reiterated their intention to keep the franc among the most stable currencies within the EMS and noted that developments in relative inflation differentials vis-à-vis Germany since the March 1983 realignment lent credence to this intention. The authorities indicated that cooperation with Belgium within the Belgium-Luxembourg Economic Union was proceeding smoothly.

The authorities accepted that their official development aid (ODA), at around 0.2 percent of GDP in recent years was low by international standards and given the per capita income of the country. However, they drew attention to the large share of multilateral aid, and to the fact that bilateral aid consisted fully of grants. Recently, Luxembourg had turned toward cofinancing projects with the European Investment Bank Moreover, the Government planned the creation of a national fund for development aid which would combine private and official contributions.

III. Outlook

Activity is expected to remain relatively firm in 1985, and GDP could rise by around 2 percent. Order book data suggest a high, but not rising, level of output and exports in the steel sector, while the expansion of the new industries and of the retail banking sector is likely to continue. On the demand side, the slowdown of external markets could be offset by a pickup in personal demand and investment. The first cost of living adjustment under the revised indexation provisions is not expected to be made until July/August 1985. However, recent wage settlements suggest that wage drift could continue to be strong and that wage developments might slow the reduction in inflation; consumer prices are projected to rise by around 6 percent for the year. While employment might rise slightly, unemployment is not likely to decline, as participation rates appear to be rising.

A stabilization of growth at the current rate will require a continuing restructuring of the economy. Although the high level of labor productivity in the steel sector supports the authorities' claim that the sector has returned to economic viability, the steel sector is unlikely to resume its earlier role as a growth leader. The strong expansion of the market for personal banking services on the other hand, as well as new ventures in telecommunications and industry, offer more promising prospects. However these sectors are highly competitive and their success will depend not least on the evolution of labor costs.

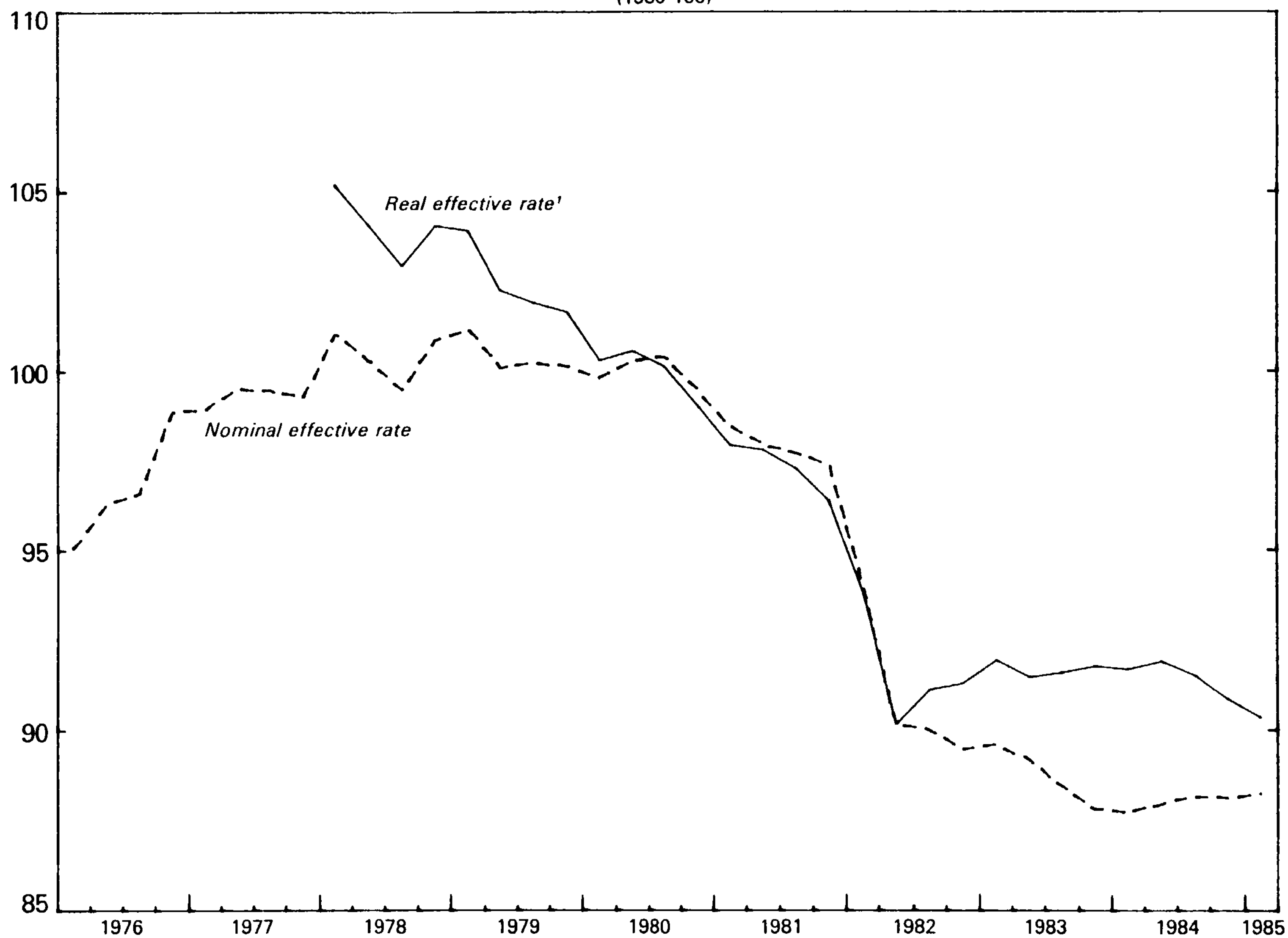
1/ For a detailed evaluation of the exchange rate position of the Luxembourg/Belgian franc see SM/84/279, pp. 78-80.

CHART 3

LUXEMBOURG

EXCHANGE RATES

(1980=100)



Sources: IMF, *International Financial Statistics;* and staff calculations.

[1] Nominal effective rate corrected for differentials in consumer prices.

IV. Staff Appraisal

Starting in the 1970s, Luxembourg has endeavored to restructure its economy. This effort has been notable both for the measure of its success, and for the orderly manner in which it was planned and implemented. The steel industry is now much leaner and more efficient; labor productivity has risen to high levels. The banking sector has diversified into new activities; retail banking increasingly contributes to activity and employment and strengthens the vitality of Luxembourg as a financial center. Finally, new nonsteel industries have been attracted to Luxembourg and existing firms have expanded their activities.

One dividend of this successful adjustment has been a continued high level of employment. Despite some statistical uncertainties, it is clear that the large personnel reductions in the steel sector have, by and large, been offset by gains of employment elsewhere, primarily in private services. As a result, Luxembourg suffered no net employment loss since 1980 and employment of foreigners continued to rise. Another dividend has been an almost uninterrupted, if modest, positive growth in real GDP, so that the country's high standard of living has been maintained. Finally, the readiness of the population to accept an increase in the burden of taxation and the authorities' determination in avoiding large cumulative public sector deficits have held down the level of the public debt.

However, there is need for caution. The inventory cycle resulted in 1984 in a stronger steel market than is likely to be the case over the medium term, while in other manufacturing industries, few new projects are now under consideration. Moreover, while the personal banking sector is expanding, competition is stiff and likely to sharpen in this and in other areas of banking activities. It is essential, therefore, that favorable developments in 1984 do not lead to complacency.

In this respect, recent wage developments are a source of concern. The return to wage indexation renews the exposure of the economy to terms of trade shocks and the staff regrets its re-introduction. Given the large increases in real wages in the steel sector in 1984, at the same time as a new package of public aid to that sector was introduced, it cannot be surprising that pressures for real wage gains are rising in all sectors of the economy, and that the tolerance for "solidarity taxes" in favor of the steel sector is waning. Together, these developments dim the prospects for continued structural adjustment in existing industries and for attracting new ventures, both of which are necessary to sustain employment and income over the medium term.

Against these developments it is especially important to maintain the country's tradition of fiscal prudence. The 1983 restructuring program established that the restructuring process would ultimately be completed without net public borrowing and that the higher tax rates necessary for this purpose should be transitory. The Government has reaffirmed and demonstrated its commitment to a fiscally balanced restructuring operation. The staff welcomes this policy, as the financial credibility of Luxembourg requires that the fiscal accounts be in balance over the medium term. Prudent fiscal management is also well suited to the present circumstances of high cyclical activity and probably excessive personal income growth. At the same time, the need to improve incentives domestically and to foreign investors by reducing and restructuring the tax burden calls for the reversal of the transitory tax increases of 1983. The staff therefore welcomes the intention of the authorities to reduce and restructure the tax burden; should indirect tax increases be retained, a full scaling back of the tax burden would thus call for offsetting reductions in direct tax rates. Accordingly, new expenditure programs in the 1986 budget should be contained to the room created by strict expenditure guidelines on existing programs.

In the area of monetary policy, the staff welcomes the strenghtening of bank supervision in line with international practice. The staff also welcomes the move to a more flexible interest rate policy in the management of government bond issues and notes the authorities' commitment to an exchange rate policy that keeps the Luxembourg/Belgian franc in the zone of the most stable currencies within the EMS. This commitment will require continued vigilance with respect to domestic wage and price developments.

Luxembourg's official development assistance, at less than 0.2 percent of GDP on a commitment basis, is well below the average for industrial countries and the staff hopes that it can be increased rapidly.

It is recommended that the next Article IV consultation with Luxembourg be held on an 18-month cycle.

Luxembourg - Fund Relations

(As of April 30, 1985)

I. Membership Status

Luxembourg has been a member of the Fund since its inception on December 27, 1945. Luxembourg accepted the obligations of Article VIII, Sections 2, 3, and 4, of the Fund's Article of Agreement as from February 15, 1961.

A. Financial Relations

II. General Department

(a) Quota: SDR 77.0 million

(b) Total Fund holdings of Luxembourg francs:
SDR 64.8 million (84.2 percent of quota).

(c) Fund credit:
None.

(d) Reserve tranche position:
SDR 12.2 million (15.9 percent of quota)

(e) Current operational budget:
Transfers: SDR --; Receipts: --

(f) Lending to the Fund (SDR millions):

	Limits	Outstanding	Uncalled
GAB	--	--	--
SFF	--	--	--
Enlarged access	--	--	--
Total	--	--	--

III. Current Stand-By or Extended Arrangement and Special Facilities

No use of Fund credit during the last 10 years.

IV. SDR Department

(a) Net cumulative allocation: SDR 16.96 million.

(b) Holdings: SDR 16.71 million, or 98.5 percent of net cumulative allocation.

(c) Current Designation Plan: Limit: --; Holdings: --

V. Administered Accounts

Not applicable.

VI. Overdue Obligations to the Fund

None.

B. Nonfinancial Relations

VII. Exchange Rate Arrangements

Luxembourg forms a monetary union with Belgium in which the Luxembourg and the Belgian franc are at par. The two countries have a dual exchange market. In the financial market, through which most capital and some current transactions are channeled, the franc is allowed to float freely. In the official market, a maximum margin of 2.25 percent is maintained between the Belgian and Luxembourg francs and the currencies of other countries participating in the European Monetary System (EMS), with the exception of the Italian lira for which the margins are 6 percent.

VIII. The last Article IV Consultation

The staff report for the 1983 Article IV consultation with Luxembourg was considered by the Executive Board (EBM/84/10, 1/20/84). No decision was taken at the time with regard to the dual exchange market arrangements. It was decided that the timing of the next Article IV consultation with Luxembourg would be determined in a flexible manner--with an outside limit of 18 months--taking into account ongoing developments.

Luxembourg - Basic Data

Population (end-1984): 365.5 thousand
GDP per capita (1984): 1/ US$10,175

National accounts (in current Lux F billions and in percent of GDP)

	1974		1984 2/	
	Lux F	Percent	Lux F	Percent
Private consumption	43.0	45.2	109.4	50.9
Public consumption	10.7	11.3	29.9	13.9
Gross fixed capital formation	23.0	24.2	42.1	19.6
Exports of goods and services	94.2	98.9	213.0	99.1
Imports of goods and services	74.0	77.9	180.0	83.8
GDP	95.0	100.0	214.9	100.0

Selected economic data (percentage changes)	1980	1981	1982	1983	1984 2/
Private consumption 3/	2.9	1.9	1.0	-1.5	0.5
Public consumption 3/	3.1	1.2	0.9	0.1	--
Gross fixed capital formation 3/	11.6	6.7	2.4	-7.2	-1.4
Foreign balance 3/4/	-5.2	0.9	1.1	3.1	2.8
GDP 2/3/	1.1	0.8	0.9	1.9	2.5
Industrial production 5/	-2.7	-5.3	1.8	4.5	11.8
Employment	0.8	0.3	-0.3	-0.3	0.4
Unemployment rate (in percent)	0.7	1.0	1.2	1.6	1.7
Consumer prices	6.3	8.1	9.4	8.7	5.6
Hourly remunerations in industry	7.9	6.8	8.6	7.6	8.7
Unit labor costs in industry	7.9	11.1	3.7	-3.0	-5.0
Money plus quasi-money 6/	19.2	8.8	1.2	7.3	0.6
Public finances (in percent of GDP)					
Central Government 7/					
Expenditure	31.9	33.1	32.7	36.9	32.6
Revenue	32.4	31.6	31.9	34.3	33.3
Financial balance	-0.5	-1.5	-0.8	-2.6	0.7

External accounts (in Lux F billions)	1980	1981	1982	1983 2/	1984 8/
Exports of goods	87.9	88.6	101.9	111.5	...
Imports of goods	105.6	111.3	124.6	136.2	...
Trade balance	-17.7	-22.7	-22.7	-24.7	...
Exports of services 9/	53.6	62.5	69.9	76.3	...
Imports of services	21.2	23.5	86.1	28.5	...
Services balance	32.4	39.0	43.8	47.8	...
Balance on goods and services	14.7	16.3	21.1	23.1	...
Transfer balance	-1.8	-2.6	-3.5	-4.0	...
Current account	12.9	13.7	17.6	19.1	...
(In percent of GDP)	(8.5)	(8.4)	(9.8)	(9.6)	(...)

1/ Staff calculation of GDP; used throughout this data sheet.
2/ Partly estimated.
3/ In constant 1975 prices.
4/ Contribution to growth.
5/ Excluding construction.
6/ December on December.
7/ Central government excluding borrowing transactions.
8/ Data not yet available because the separation of balance of payments data for the Belgium-Luxembourg Economic Union (UEBL) into their country components typically follows with a long lag.
9/ Based on staff calculations for exports of banking services.

Luxembourg - Statistical Issues

1. Outstanding Statistical Issues

a. Monetary statistics

The IFS page for Luxembourg needs to be modified to incorporate information on the newly established Luxembourg Monetary Institute, to take account of official estimates of the Belgian franc in circulation in Luxembourg, and to include nonmonetary financial institutions. There is also a longstanding problem in that Luxembourg's monetary statistics include the balance sheets of bank branches operating abroad.

b. Government finance

The 1984 GFS Yearbook contains comprehensive consolidated government finance statistics through 1982. GFS data, based on the information published in the Yearbook, are to be included in the next issue of IFS.

c. Balance of payments

Balance of payments statistics are not available separately for Luxembourg. Balance of payments statistics for the Belgium-Luxembourg Economic Union are included in the IFS country page for Belgium.

d. General economy

The compilation of unit value indices for Luxembourg's trade with countries outside the Belgian-Luxembourg Economic Union was to be finalized at the end of 1984. As of this date, the Bureau of Statistics has not received data or other information on the methodology of these new indices.

While data on consumer prices are reasonably up-to-date, Luxembourg does not supply current data on industrial production, employment and foreign trade.

e. National accounts

There is currently a substantial lag in the availability of data.

2. Coverage, Currentness, and Reporting of Data in IFS

The table below shows the currentness and coverage of data published in the country page for Luxembourg in the April 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by the Luxembourg Monetary Institute, which during the past year have been provided on a timely basis.

Balance of payments data for the Belgium-Luxembourg Economic Union are based on reports sent to the Fund's Bureau of Statistics by the Banque Nationale de Belgique, which during the past year have been provided on an irregular basis.

Status of IFS Data

		Latest Data in April 1985 IFS
Real Sector	- National Accounts	1981
	- Prices: CPI	December 1984
	- Production: Industrial	Q4 1983
	Steel	Q4 1983
	- Employment: Industrial	Q4 1983
	Steel Industry	Q4 1983
	- Earnings	n.a.
Government Finance	- Deficit/Surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.
Monetary Accounts	- Monetary Authorities	n.a.
	- Deposit Money Banks	December 1984
	- Other Financial Institutions	February 1985
External Sector	- Merchandise Trade: Values	n.a.
	- Merchandise Trade: Prices	n.a.
	- Balance of Payments	Q1 1984
	- International Reserves	n.a.
	- Exchange Rates	February 1985

Table 2. Luxembourg: Public Finances

(In billions of Luxembourg francs and in percent of GDP) 1/

	1980	1981	1982	1983		1984		1985	
	Outcome			Budget 2/	Outcome	Budget 2/	Outcome 3/	Budget 4/	Estimate 5/
Central Government 6/	-0.7	-2.6	-1.6	-9.1	-5.4	-1.5	1.6	0.6	0.3
Revenue	(47.2)	(51.1)	(57.3)	(59.4)	(67.6)	(65.1)	(71.6)	(72.6)	(77.5)
Expenditure	(47.9)	(53.7)	(58.9)	(68.5)	(73.0)	(66.6)	(70.0)	(72.0)	(77.2)
Special central government funds (Fonds de l'Etat)	-1.6	-1.2	-1.1	-0.7	-0.7	-1.8	0.2	--	2.9
Consolidated Central Government	-2.3	-3.8	-2.7	-9.8	-6.1	-3.3	1.8	0.6	3.2
(In percent of GDP)	(-1.5)	(-2.3)	(-1.5)	(-4.9)	(-3.1)	(-1.5)	(0.8)	(0.3)	(1.4)
Impact of restructuring program 7/	--	--	--	-5.3	-5.3	0.9	1.2	0.4	2.2
Consolidated Central Government excluding restructuring program	-2.3	-3.8	-2.7	-4.5	-0.8	-4.2	0.6	0.2	1.0
Central government debt	10.5	11.4	13.0	16.3	16.3	18.6	18.6	18.6	18.6
Central government reserves 8/	12.4	9.6	8.5	2.0	5.7	4.7	9.8	10.4	13.0
General Government 9/	-1.5	-1.9	-1.1	...	--	...	1.4	...	2.1
Revenue	46.7	47.0	47.5	...	50.6	...	49.8	...	50.0
Expenditure	48.2	48.9	48.6	...	50.6	...	48.4	...	48.9
Debt (gross)	12.3	12.6	12.9	...	13.1	...	12.7	...	12.3
Local authorities 10/	-0.4	-1.0	0.3	...	-1.2	-1.4	...	...	...

Sources: Ministry of Finance, Budget Proposal for 1985; data supplied by the authorities; and staff calculations.

1/ GDP as calculated by the staff.

2/ Final budget.

3/ Preliminary outcome. Expenditure of the Central Government includes Lux F 1.4 billion in transfers to the special funds that have been advanced from the 1985 to the 1984 budget exercise.

4/ Voted budget, including Lux F 2.7 billion of fresh aid to the steel industry. Data for special funds are staff estimates.

5/ Staff estimates. Assumes that Lux F 2.9 billion of the budget surplus of 1984 will be transferred to the investment funds in 1985.

6/ Excluding borrowing and redemption of debt, both of which are typically included in the national presentation.

7/ Law of July 1, 1983. For 1985 fresh aid to the steel industry (Lux F 2.7 billion) has been included.

8/ Central government budgetary reserves plus reserves of the special central government funds.

9/ In percent of GDP.

10/ In billions of Luxembourg francs.