

The Governor's Message



In 2008, Luxembourg was struck by the global financial and economic crises. The financial turmoil that developed from August 2007 in the United States subprime market gradually affected Europe and emerging countries, spreading from the financial sector to the real economy. The macroeconomic projections for Luxembourg, issued by the BCL as well as by other national, international and supranational institutions (IMF, European Commission), were revised downwards several times. We are facing an unprecedented recession, which appears as one of the steepest in the European Union.

This crisis contrasts with the decade that followed the introduction of the euro, when Luxembourg witnessed steady employment growth. The single currency played a part in that trend and still entails many benefits, for the euro zone as well as for Luxembourg, namely thanks to its ability to mitigate the impacts of the crisis. Without the euro, Europe would have faced erratic movements of intra-European exchange rates and interest rates, reminiscent of past episodes such as the crisis of the European monetary system in 1992-1993. Such volatility would have aggravated the impact of the crisis even more.

Another benefit of the euro results from the involvement of the Luxembourg Central Bank in monetary policy. The esta-

blishment of the BCL also entailed a major benefit for the national economy, namely because of the close links between the BCL and several prominent national and European actors.

Basing monetary policy on clear rules, thus allowing a better anchoring of inflation expectations, is another benefit brought about by the euro. This policy permitted the stabilisation and containment of inflation within the euro area. Nevertheless, the general trend regarding Luxembourg is that of a higher level of inflation than in the rest of the euro area; Luxembourg's cost-salary competitiveness developed in a way that was incompatible with a monetary union.

At the European level, the euro also facilitated the integration of the goods and services markets, as well as of the financial markets. This resulted in significant benefits for a small open economy such as Luxembourg's.

As far as the BCL is concerned, it has had to face a triple challenge since its creation: the challenge of finding its niche in the national institutional landscape, as a European-rooted, constitutionally independent institution; the challenge of making itself heard at the European level, in spite of relatively limited human and financial resources; and the challenge of ensuring optimal financial and human management, in the light of its European missions and international developments. Above and beyond these came the challenge of meeting the financial and economic crises in 2008.

At first, faced with inflationary pressures, the Governing Council of the ECB increased its main interest rate by 25 basis points in July 2008. In October, nonetheless, in a context of higher uncertainties and the fall of inflationary pressures, the ECB decided, in conjunction with other prominent central banks, to lower its main interest rate. Between late September 2008 and May 2009, the main interest rate was decreased by 325 basis points in total. This represents the sharpest decrease recorded since the creation of the Eurosystem. In order to remedy the drying-up of the interbank market, the Governing Council also adopted, in late 2008, new liquidity management measures. Among these were the adoption of a fixed rate tender procedure with full allotment for weekly main refinancing operations, and a temporary expansion of the list of assets eligible as collateral in Eurosystem credit operations, associated with an enhancement of risk control measures. In May 2009, the Governing Council decided to introduce temporarily several non-standard monetary policy measures: the granting to the EIB of the status of eligible Eurosystem monetary policy counterparty, the conduct of liquidity-providing longer-term refinancing operations with a maturity of one year, and a purchase programme for euro-denominated covered bonds issued in the euro area.

After its real GDP fell by 4.5% in the last quarter of 2008, Luxembourg will have to face a contraction spillover in 2009 (resulting from a negative base effect), amounting to 3.5%. Furthermore, economic activity kept declining in the course of the first quarter of 2009. Industrial output underwent a decrease of 7.4%. The financial sector also experienced a reduction in activity, though less pronounced than during the last quarter of 2008. This can be witnessed, for instance, through a better resistance of the net asset value of undertakings for collective investment, which decreased by 4% in the first quarter, a less dismal performance than in the last quarter of 2008 when the decline had reached 14%.

The first indicators of an economic stabilisation – even though their level is still low – emerged in the second quarter of 2009. First, stock markets witnessed some gains. Moreover, several indicators taken from conjuncture surveys have shown a consolidation, and even an improvement in some cases.

For 2009 on the whole, the BCL expects a growth rate between -5% and -4.4%, reflecting the important contraction spillover. The GDP in volume should stagnate in 2010 and show a progression between 1.4% and 3% in 2011, which appears relatively weak in comparison with the growth rates of the last two decades in Luxembourg. The issue most at stake, therefore, is not only the impact of the crisis on the present GDP level, but its impact on the potential growth rate of our economy. Lower than expected potential growth would complicate the financing of expensive social benefits and force Luxembourg to pay more attention to the maintenance of its competitiveness.

In any case, potential growth could be negatively affected by several risk factors directly linked to developments in the Luxembourg financial centre. In particular, the impact of bank restructurings in neighbouring countries will be significant for Luxembourg. Moreover, productivity in the banking sector could be persistently affected by the crisis, affecting the Luxembourg economy which heavily relies on this sector.

As usual, the labour market reacted with some delay to the decline in economic activity. Employment increased by nearly 5% in the course of 2008 on the whole, with an average yearly unemployment rate of 4.4%. The apparent dichotomy between economic activity and employment in 2008, which mechanically implied a decrease in apparent work productivity, can be explained by the existence of a powerful shock-absorber: partial unemployment. In July 2009, more than 11 000 people were concerned by this measure.

This shock-absorber, however, will not be sufficient to protect permanently the labour market from the hazards of the business cycle. Besides, apparent productivity will need to recover, in order to avoid an excessively pronounced degradation of companies' operational results. According to the BCL's projections, paid employment will decrease by 0.2% in 2009 and by some 1.7% in 2010, before stabilising in 2011. Thus, the unemployment rate will go up from 4.4% in 2008, to 5.6% in 2009, 6.7% in 2010 and 7% in 2011.

The labour market's degradation will negatively affect the evolution of average labour costs. In nominal terms, the latter would only increase by 0.6% and 0.4% in 2009 and 2010. On the other hand, the increase would reach 2.5% in 2011, due to the enforcement of an index bracket at the beginning of year.

Because of several factors, namely the economic crisis, the evolution of commodity prices and the slowing down of salary increases, the progression rates of NCPI and HCPI would only amount to 0.2% and -0.2% in 2009. An increase of the inflation rate is, however, expected for 2010, due to the increase of the energy component. In 2011, inflation in the services' sector would be stimulated by the index bracket mentioned above.

Containing any lasting revival of inflation – which might accelerate during a forthcoming recovery in the absence of the required vigilance – is of paramount importance. Keeping inflation in check is all the more important as Luxembourg's competitiveness is still at risk. Thus, the BCL's calculations expect a deterioration, in the course of 2009-2011, of the two indicators of price-competitiveness, the one based on consumer prices (except in 2009) and the one inferred from the GDP's deflator. The indicator based on unit labour costs in the whole economy would improve slightly in 2009 and 2010 and would only slightly deteriorate in 2011. It is worth remembering that these predictable developments are based on a pronounced deterioration of those three indicators between 2000 and 2008. As for the period 2009-2011, there is no sign that this tendency is likely to change.

The crisis will also have a significant impact on the state's fiscal revenues. If public sector revenues were still dynamic in 2008, the current financial crisis will heavily weigh on them in the years to come. Besides, the national recovery plan brought about additional spending, with a counter-cyclical objective. This spending was topped by the fiscal cost of partial unemployment and an increase in unemployment benefits. While public administrations still achieved a surplus of 2.6% of GDP in 2008, they are expected to experience a deficit close to 4% in 2009, thereby exceeding, for the first time since the introduction of the euro, the 3% threshold imposed by the Treaty on the European Union. Besides, the fiscal situation would continue to worsen in 2010 and 2011. This noxious development is not solely linked to the economic and financial crisis. Thus, the public administrations' balance, adjusted for economic cycles, would also become clearly negative, amounting to 5% of GDP in 2011 in the case of unchanged policy.

Due to the combined effects of these important structural deficits and the increasing trend regarding social security and pensions expenditure, Luxembourg could rapidly be confronted by powerful indebtedness dynamics, should no new structural measures be taken, as shown by several simulations carried out in the present report and yet using dissimilar tools (accounting projections on the one hand; general balance models on the other hand).

An important effort of fiscal consolidation is required in this context. It should be two-fold. First, it is essential to retrieve, as soon as possible, when the economy so permits, structural surpluses of at least 1.5% of GDP. Second, it is necessary to carry out, without further delay, a reform of social security, especially in the field of pensions. Only a strategy that takes those two aspects into account will allow Luxembourg to ensure the long-term sustainability of its public finances, which currently appears endangered.

More generally, structural measures are indispensable, both for entailing a sustainable stabilisation of public finances, and for improving the competitiveness and the productivity of the Luxembourg economy, namely in the fields of education, research and infrastructures.

In order to reinforce support to the financial sector and the economy on the whole in the context of a deepening financial crisis, the BCL strongly increased the degree of intermediation towards its domestic counterparties in the course of 2008. The Bank's balance sheet went up by 71% in 2008, increasing from 59 billion euro at end-2007 to 100.6 billion euro at end-2008. The BCL remains the third most important national central bank as far as liquidity allocation in the Eurosystem is concerned. Nevertheless, the BCL's capitalisation remains low relative to its stabilising role in the current crisis.

The BCL, having been granted a new regulatory competence by the law of 24 October 2008, has become a proper supervisory authority and intends to develop its enlarged competences in full cooperation with the Government and the other authorities, on the national and international level. Besides, it issued a regulation relative to liquidity supervision on 29 April 2009. In this context, ongoing discussions taking place in international or regional fora (G20, FSF recently renamed FSB, de Larosière Group, CEBS, BSC, EFC...) have tackled issues such as regulatory deficiencies, inadequate macro-prudential supervision, and the necessary reform of the supervisory architecture.

The BCL implemented a revision of its organisation chart on 1 January 2009, allowing an optimal allotment between its new missions and the mobilisation of competent teams, which will be reinforced in the course of 2009, helping the BCL honour its obligations concerning financial stability. This crisis period has demanded exceptional efforts from all staff members of the BCL; I insist on thanking them for their professionalism and their strong commitment.

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