



THE
GOVERNOR'S
MESSAGE

The euro area GDP decreased by 4.1% in 2009. The economic recovery took hold ever since, but it will probably be characterised by low and quite volatile rates of growth. In Luxembourg, GDP declined by no less than 3.4% in 2009, which has been the worst result since 1975. The recession lasted five quarters, from the second quarter of 2008 to the second quarter of 2009, and real GDP decreased by 7% over this period. The discrepancy with respect to the trend growth rate observed from 1960 to 2007 therefore amounted to more than 10% during this phase. The revival recorded during the second half of 2009 and the positive impetus observed at the beginning of 2010 augur a GDP growth rate between 1.8 and 2.8% in 2011 and between 2.5 and 3.9% in 2012. This confirms that the Luxembourg economy is no longer able to record the high growth rates of 4% or more observed in the past, which underlay the so-called Luxembourg social model.

I would like to draw your attention to the high uncertainty that surrounds these projections. On the one hand, the fiscal consolidation measures adopted – or likely to be adopted – in most European countries are not fully integrated in the projections, which only take into account the measures already announced and sufficiently spelled out. The implementation of these plans is essential, in order to defuse as quickly as possible the public finance crisis. However, in the short term these plans could also dampen the external demand directed to Luxembourg.

On the other hand, the prospects of the financial sector are uncertain and the macroeconomic performances of Luxembourg closely depend on the evolution of financial markets. The Luxembourg financial centre at first sight exhibits a strong resilience to the financial crisis. However, this prima facie evidence could quickly prove wrong. The impact of the crisis on the financial centre is still difficult to assess at this juncture. The exposure of the Luxembourg banking sector on the Italian, Spanish, Greek and Portuguese sovereign risk is still significant and the absence of a resolution fund in Luxembourg could magnify this vulnerability. A cautious and responsible policy is required in these circumstances, as well as more efficient constitutional arrangements.

Real GDP will have stagnated from the end of 2007 to the beginning of 2011, compared to a "normal" rate of economic growth estimated at 4% a year in Luxembourg prior to the crisis. The Luxembourg authorities must grasp this new economic reality and adopt as soon as possible the indispensable structural reforms. Otherwise, Luxembourg will no longer be able to address successfully the manifold present-day challenges. The labour market must be reformed, on economic and in particular social grounds. The employment growth rate decelerated markedly in Luxembourg. Whereas total employment still grew by more than 5% a year before the recession, it is now at a standstill. The unemployment rate has as a result reached the historically high level of 6%, in spite of several dampening effects like cross-border workers, the use of short-term unemployment and the so-called "employment measures".

Unemployment becomes deeply entrenched in Luxembourg, due *inter alia* to the spectacular drift of unit wages, compared to our major trading partners, since the end of the nineties. Luxembourg belongs to a monetary union and should therefore act in a more responsible way as regards public finances and competitiveness. After the courageous reforms implemented in several foreign countries, Luxembourg is now among the worst European Union Member States with respect to labour costs and productivity. The current wage indexation mechanism is not compatible with our membership in such a union. Automatic, full indexation is all the more damaging as our inflation tends to exceed the inflation rate recorded in our neighbouring countries. Our inflation projections suggest that this trend will continue unscathed over the next years, unless decisive actions are adopted in this field.

As Luxembourg cannot resort to external devaluations, it should proceed as soon as possible to an "internal devaluation", namely to a cost confinement policy. Such a policy could be stimulated at the European level, as illustrated by the creation of a new governance task force under the aegis of the President of the European Council. The task force could recommend multilateral surveillance mechanisms as far as competitiveness is concerned. Luxembourg must as quickly as possible remedy to its low productivity, via *inter alia* an efficient economic diversification policy. An internal reallocation of public expenditure in favour of education, research and training would favour such a strategy.

The authorities also have to face reality as far as public finances are concerned. BCL has repeatedly underlined over the last few years the drift in our public finances, which earned the bank the nickname "Cassandra". Our only problem is that we basically – albeit to a lesser extent than many observers – underestimated the real extent of the challenge. The Luxembourg general government posted a deficit of 0.7% of GDP in 2009. According to our projections, the deficit should be below but close to the 3% reference value in 2010, for the first time since the establishment of the ESA 95 harmonised accounts. This reference value would even be breached from 2011 onwards due to lower direct taxes on corporations and to a still relatively sustained increase in current expenditure. Public debt would amount to 29% of GDP in 2012, namely about four times the level recorded in 2007.

The measures announced by the Prime Minister on 5 May 2010 would, according to mechanistic estimates, decrease the general government deficit by a little more than 1% of GDP from 2011 onwards. According to our estimations, lower current expenditure accounts for at most one fourth of the global consolidation package, whereas higher taxes represent about one half of this package. This latter element could prove detrimental to economic growth.

A different picture emerges once the adverse impacts of higher taxes, *inter alia* on labour supply, are taken into account. These adverse impacts would indeed dampen to a considerable extent the budgetary impact of the new consolidation measures. According to the BCL general equilibrium model, this favourable impact would reach at most 0.4% of GDP over the medium term, compared to 1% of GDP for the "static" effect. The BCL has always argued for expenditure restraint – Luxembourg is on the top of the European league as regards both public expenditure per head and the increase in expenditure. An austerity package focused on higher taxes rather than on a more responsible expenditure policy spoils the Luxembourg economy, and this in turn harms public finances. The ultimate result is a weak economy and a mitigated decrease of the fiscal deficit.

The consolidation effort presented by the Luxembourg government is only a first and grossly insufficient step towards a lasting improvement in our public finances. The latter are penalised by a high central government deficit and by the high implicit liabilities connected to social transfers – pensions in particular. Only a resolute action based on the conjunction of two pillars could ensure the sustainability of our public finances. The first pillar is the implementation of the EUR 1.5 billion

effort presented in the 11th update of the Luxembourg Stability Programme. The second pillar is a structural reform of the social security system, focused in particular on a "ticking time bomb", namely the pension systems. The actuarial neutrality of pensions should be guaranteed. In other words, the "pensions versus contributions" principle should be plainly complied with, *inter alia* via a less generous treatment of the so-called "assimilated" years. In addition, the effective retirement rate should be raised. Finally, the full adjustment of pensions to real wages should be severed or at least confined to the lower pensions. The healthcare system, whose financial situation is constantly deteriorating, should also be monitored closely by the authorities.

Should the government rest on the measures announced on 5 May 2010, the consolidated debt ratio would exceed the 60% of GDP reference value around 2027. It would increase in an exponential way afterwards. Any subsequent adjustment would be extremely costly in these circumstances – also from a social viewpoint. This shows that an early and coherent consolidation strategy is the best one also from a distributive viewpoint.

These indispensable quantitative adjustments should be accompanied with more qualitative improvements of the institutional framework presiding over budgetary policy. The BCL has repeatedly advocated what is at present discussed at the European level, namely the establishment of an independent fiscal body. In Luxembourg, such a body would make it easier to coordinate the macroeconomic projections that underlie the budget process and to choose an appropriate evolution of expenditure. A more tangible expenditure rule would also be extremely useful. The current one is only one aspect of the coalition agreement. This new expenditure norm could be monitored by the independent fiscal body. Finally, the budget should be presented in line with programmes and performance indicators rather than with a view to administrative traditions. This debate about a more efficient budgetary governance framework should begin as soon as possible in Luxembourg and should proceed in parallel to the similar discussions at the European level.

The BCL is clearly deeply entrenched in the European debate, most notably the euro area, as illustrated for instance by the launch by Clearstream of LuxCSD, namely a new central depository service for securities in Luxembourg and other countries. LuxCSD will make it possible to settle securities transactions in central bank money, which will decrease the related risks for financial market participants. LuxCSD should become operational during the first half of 2011. It will also ease the connection of market participants to TARGET2 Securities.

The BCL also closely monitors the evolution of the institutional architecture of Europe, *inter alia* the European Systemic Risk Board (ESRB), in which the BCL plays a role. At the national level, legislative changes related to the BCL organic law are also envisaged.

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