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IMF Concludes 2004 Article IV Consultation with Luxembourg

On April 28, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Luxembourg.¹

Background

Following a prolonged slowdown in economic activity, an externally-driven upswing appears in the offing, although various obstacles are likely to hinder a return to the impressive 5.5 percent average real GDP growth rate of 1980-2000. The financial sector is still adjusting to the bursting of the global equity bubble. Also, relatively generous wage settlements and falling productivity caused a significant increase in unit labor costs that reduced corporate profitability and competitiveness, which has also been weakened by the appreciation of the euro. Sluggish activity interacted with generous welfare benefits to raise unemployment, while labor force participation remains relatively low, particularly of older residents.

The authorities are adjusting policies to the growth slowdown, although major new initiatives are on hold in the run-up to the June 2004 general election. Tax cuts, high expenditure, and weak

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

activity are estimated to have caused a general government deficit in 2003, the first in two decades. To forestall a large deterioration, expenditure growth is programmed to slow to about 4.3 percent in 2004, down from near double-digit growth rates in previous years. Some reforms and adjustments to entitlement programs are supporting this deceleration. Nonetheless, absent further measures the general government deficit is projected to rise through 2005, as corporate tax receipts react with a lag to the economic slowdown. Gross debt remains low and net assets high.

Executive Board Assessment

Directors welcomed indications that real GDP growth is rebounding, following an unusually long period of sluggish activity. However, they stressed that medium-run growth prospects are now less buoyant in comparison to the exceptional growth performance of the past decade, as productivity growth and the expansion of the financial sector have slowed. Two key challenges in the period ahead will be, first, to adapt fiscal policy to the slower growth environment through a marked deceleration of expenditure increases, and second, to enhance the economy's resilience to unforeseen developments through entitlement and labor market reforms. Directors urged the government to design and implement soon after the general elections a comprehensive strategy to address these challenges, with a view to preserving the economy's attractiveness for business in Luxembourg.

Considering the high mobility of factors of production and the demographic pressures that lie ahead, Directors supported the official fiscal policy objective to run a small general government surplus over the medium run without increasing the tax burden. However, attaining this objective will be difficult because of the depth and duration of the current growth slowdown, and will require that expenditures are lower than planned in the Stability Program update. A number of Directors also pointed to the importance of observing the 3 percent of GDP deficit ceiling. While Directors agreed that fiscal adjustment could be stretched over time because of the public sector's favorable net asset position, they encouraged the authorities to eliminate the general government deficit soon after 2006, unless real GDP growth disappoints significantly; several Directors, however, highlighted the benefits of more rapid adjustment.

Directors stressed that expenditure restraint would be key to improving the public finances. Tight control of discretionary spending will be needed in 2004, to avoid overshooting the general government deficit target. Directors called for a more comprehensive adjustment strategy to sustain the deceleration in spending over the medium run, centered on cutbacks in subsidies, a better targeting of jobless support, and health care and pension reforms.

Regarding expenditure on entitlements, Directors underscored the benefits of addressing aging-related pressures proactively and early, to limit the risks for potentially deleterious payroll tax hikes later on. In the health care system, various measures could be considered, including raising the proportion of medical expenses paid out-of-pocket. For old-age pensions, most Directors encouraged the authorities to consider building up a mandatory fully-funded pillar, in particular in order to mitigate risks related to the high degree of mobility of the workforce. Alternatively, the rate of replacement of pre-retirement income under the pension scheme could

be formally linked to the pension contribution base, and the statutory retirement age could be linked to life expectancy. Some Directors recommended reviewing the pension system before 2006, and reviewing it thereafter more often than every 7 years.

Directors observed that employment growth has remained robust, supported by a strong inflow of commuters to jobs in Luxembourg. At the same time, unemployment among residents has increased steadily, and the rate of participation of older workers in the labor force is low, owing to a generous social welfare policy. Directors supported the authorities' efforts to improve the targeting of the support for the jobless and curtail the abuse of disability pensions. However, more fundamental reforms should be considered. In particular, for young workers, the shortened work experience requirement for access to unemployment benefits could be aligned with that for other workers. For older workers, on-the-job training could be improved and various incentives to drop out of the labor force early, notably in the pension system, eliminated. More generally, gradual reductions in the replacement rate of minimum income should be considered to strengthen the incentive to work for those who are fully able to.

Directors observed that recent developments had confirmed that Luxembourg's financial sector is robust, efficient, and well supervised, as assessed in the 2002 FSAP. Directors welcomed recent steps to improve financial sector supervision, which will help to maintain the sector's robustness as global competition intensifies and taxation is harmonized. They noted that the large volume of cross border financial business makes combating money laundering and the financing of terrorism (AML/CFT) an important task and challenge for the authorities. Accordingly, they endorsed the efforts to strengthen further the AML/CFT legal and implementation structure, and commended the authorities' commitment to ensure that the new AML/CFT draft law meets the highest international standards.

Directors praised Luxembourg's high level of official development assistance, and encouraged the authorities to support further multilateral reductions of agricultural subsidies and import restrictions.

Directors observed that Luxembourg's economic statistics are adequate for surveillance and have continued to improve. They encouraged further efforts to allow Luxembourg to subscribe to the Fund's Special Data Dissemination Standard.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Luxembourg: Selected Economic Indicators

	2000	2001	2002	2003 1/	2004 2/
Real economy					
Real GDP (change in percent)	9.1	1.2	1.3	1.2	2.3
Domestic demand (change in percent)	4.9	4.3	-0.6	2.2	2.5
CPI (in percent, year average)	3.2	2.7	2.1	2.6	2.1
Unemployment rate (in percent)	2.6	2.6	3.0	4.1	4.9
Gross national saving (in percent of GDP)	32.9	32.2	26.2	25.9	25.6
Gross fixed investment (in percent of GDP)	20.9	22.9	22.5	22.5	22.4
Public finances (percent of GDP)					
General government balance	6.4	6.2	2.4	-1.0	-2.6
General government gross debt	5.5	5.5	5.7	4.9	6.1
Interest rates (in percent)					
Short term rate 3/ 4/	4.4	4.3	3.3	2.3	2.1
Long-term bond yield 5/	5.9	5.4	5.3	4.3	...
Balance of payments (in percent of GDP)					
Trade balance	-12.4	-12.2	-9.6	-10.2	-10.5
Current account	12.8	8.4	8.2	5.9	6.9
Exchange rates					
Euro per US dollar 6/	1.08	1.12	1.06	0.88	0.82
Nominal effective rate (1995=100)	95.50	95.40	95.63	96.89	...
Real effective rate (CPI based; 1995=100)					

Sources: Data provided by the authorities; and IMF staff calculations.

1/ Data for 2003 are estimates as of April 6, 2004.

2/ Projections.

3/ For 2004, data refer to February.

4/ Short-term rates are for 3-month euro deposits.

5/ Average of long-term bonds traded on Luxembourg Stock Exchange. Long-term government bond yields are not available (the only 10-year government bond matures in 2007).

6/ For 2004, data refer to March 25.