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IMF Executive Board Concludes 2011 Article IV Consultation with Luxembourg

On May 13, 2010, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Luxembourg.¹

Background

Luxembourg's economy has begun its recovery. Mirroring developments in other advanced European countries, Luxembourg experienced stronger-than-expected growth in 2010. Besides fiscal stimulus, economic activity was initially underpinned by investment and restocking. But exports have increased markedly since the second quarter of 2010, notably financial services and metal products. Private consumption has also begun to gradually recover despite moderate increases in consumer lending spreads. Employment growth has been gaining pace but, despite enhanced employment support programs, the unemployment rate has not eased. Weak wage growth has tempered core inflation even though headline inflation has been boosted by global commodity price developments and administered price increases.

The financial sector has stabilized. The investment fund industry has experienced a fast recovery with total assets surpassing their pre-crisis peak, reflecting strong investor demand as well as market valuation gains. In the banking sector, there were no further failures after the peak of the crisis and restructuring has continued, including in the context of EU-approved

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. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

reorganization plans. Overall bank capitalization has increased and appears broadly adequate, but remains uneven across banks. Aggregate bank balance sheets have continued to shrink through early 2011. While interest margins have declined, bank profits have increased due to commission and fee income and lower provisioning needs.

The Financial Sector Assessment Program (FSAP) identified the main financial risks as liquidity and credit risks related to intra-group exposures and sovereign bond holdings. Luxembourg-based banks generate structural excess liquidity from their operations, which is channeled to parent banks abroad. These intra-group activities, given their size and concentration, entail liquidity and solvency risks for Luxembourg-based banks. In addition, some institutions maintain large direct exposures to sovereign risk from the EU periphery. Stress tests suggest that in a scenario of protracted slow growth in core Europe and renewed deterioration in market perceptions of sovereign risk, banks would also face indirect risks originating from exposures of their parent banking groups, particularly those incorporated in the distressed countries.

Growth is projected to slow from about 3½ percent in 2010 to about 3¼ percent in 2011 in line with prospects in core Europe. Inflation is projected to increase in 2011 reflecting global food and fuel price developments. But price pressures will likely remain subdued given slack in the economy and delays in automatic wage indexation increases.

Executive Board Assessment

Executive Directors welcomed the continued strengthening of Luxembourg's recovery and the authorities' supportive fiscal policy in 2010 as well as their role in stabilizing the financial sector. Looking ahead, Directors concurred that the key challenges are to address remaining financial sector vulnerabilities, maintain a sustainable fiscal position, and bolster competitiveness and employment creation.

Directors welcomed the FSAP update, and commended the authorities' intention to strengthen the regulatory and supervisory frameworks, in particular given the financial sector's exposure to liquidity and credit risks stemming from large intra-group exposures and sovereign bond holdings. Directors noted the plans to strengthen the powers of the supervisory authority (CSSF). They stressed the need to increase its operational independence, as well as to clarify the roles of Central Bank of Luxembourg and the CSSF regarding liquidity risk supervision. Directors highlighted the importance of strengthening the financial safety net to facilitate restructuring of problem banks on a going-concern basis, and to revamp the deposit guarantee scheme.

Directors recognized that, given the prevalence of foreign subsidiaries in Luxembourg, a number of key financial policy areas hinge on EU-level decisions. They encouraged the authorities to remain actively involved in relevant supervisory colleges. In the absence of ex-

ante burden-sharing arrangements for the resolution of cross border banks, Directors stressed the importance of seeking pragmatic solutions to facilitate cross border bank resolution, including through effective coordination between home and host authorities. They welcomed the authorities' swift progress in improving their AML/CFT framework.

Directors supported the authorities' decision to begin fiscal consolidation in 2011 and target a balanced budget by 2014. They considered that consolidation should focus primarily on the expenditure side, and advised the authorities to replace the public investment cap with current spending cuts to protect growth prospects. Directors highlighted that a medium-term fiscal framework could support consolidation by facilitating expenditure review. Given the magnitude of aging-related costs, they stressed the importance of pension and health care reforms. Directors welcomed the authorities' proposal to increase the effective retirement age, and encouraged them to expeditiously implement recent health care reforms.

Directors noted that Luxembourg's growth prospects would hinge on continued efforts to promote competitiveness. In this regard, they welcomed the authorities' intention to revise the backward-looking wage indexation mechanism and revisit employment support programs to limit adverse work incentives. Continued investment in skills development will also be needed.

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Luxembourg: Selected Economic Indicators ^{1/}

	2007	2008	2009	2010	2011 ^{2/}
Real economy	(Change in percent, unless otherwise indicated)				
Real GDP	6.6	1.4	-3.6	3.5	3.2
Gross investment	12.5	0.7	-23.2	5.1	7.1
Unemployment (as percent of the labor force)	4.4	4.4	5.8	6.0	5.9
Resident employment (thousands)	207.7	213.7	215.5	218.1	222.0
Total employment (thousands)	333.0	348.8	352.1	358.1	363.7
CPI (harmonized), p.a.	2.7	4.1	0.0	2.8	3.7
Public finances	(Percent of GDP)				
General government revenues	39.8	39.8	41.3	39.5	36.4
General government expenditures	36.2	36.9	42.2	41.2	37.3
General government balance	3.7	3.0	-0.9	-1.7	-0.9
General government gross debt	6.7	13.6	14.5	16.5	17.3
Balance of payments					
Current account balance	10.1	5.3	6.9	7.8	11.5
Balance of trade in goods and services	43.8	39.3	39.1	45.1	41.1
Factor income balance	-29.7	-29.6	-29.5	-35.7	-28.0
Transfer balance	-3.9	-4.5	-2.7	-1.6	-1.6
Exchange rates 3/	Member of the euro area				
U.S. dollar per euro	1.4	1.5	1.4	1.3	...
Nominal effective rate (2005=100)	101.5	103.9	104.9	102.1	...

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

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2/ IMF staff projections.

3/ Data for 2010 refer to December.