

**Statement by Johann Prader, Alternate Executive Director for Luxembourg,  
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We would like to thank staff for the fruitful and constructive dialogue during the 2011 Article IV mission and the Financial Sector Assessment Program Update (FSAP). The Luxembourg authorities broadly agree with staff's analysis.

**The real economy has strengthened in 2010 and the outlook is mildly positive.**

In the last quarter of 2010, the Luxembourg economy grew by 1.7 percent on a quarterly basis. For 2010 as a whole, growth reached 3.5 percent reflecting mostly a bounce back in growth from the crisis. The increases were strongest in those sectors that lost the most during the crisis e.g. manufacturing. Transportation and trade have also gained strongly. External demand from Europe and household consumption are driving the recovery. In this context, manufacturing has benefitted from partial unemployment schemes that were extended by the government in 2009 and which helped the industry to maintain the workforce and respond quickly to a resurgence of external demand. For 2011, the statistical office predicts growth just above 3 percent. Employment is picking up, with employment growth of 1.6 percent in 2010 and a slight decline in the unemployment rate in the first three months of 2011.

**Fiscal policy will be an important challenge going forward.**

In the context of an unexpectedly strong growth rebound in 2010, the fiscal deficit reached 1.7 percent of GDP, far lower than the expected 3.9 percent of GDP. For 2011, the authorities plan to exit from countercyclical fiscal policy and a deficit of 1.2 percent is foreseen. The budget includes a consolidation package amounting to 1.5 percent of GDP (1.1 percent expenditure, 0.4 percent revenues). It will yield savings of 1.4 percent of GDP in 2012.

Our authorities are skeptical of the staff's suggestion to let the automatic stabilizers operate fully up to the Maastricht limit. In their view the fiscal multiplier in Luxembourg is rather low. Moreover, the authorities are well aware of the political difficulty of rolling back fiscal deficits.

The medium term fiscal objectives include a balanced budget for 2014. In the medium term, a structural surplus of 0.5 percent of GDP should partially pre-fund the anticipated large ageing-related increase in public expenditures. Furthermore, the authorities intend to reform the budgetary framework. First steps of this reform will be introduced before 2014.

**Social Security systems need to be prepared for demographic ageing.**

In December 2010, parliament approved a health care reform which is intended mainly to reduce costs and improve efficiency in the Luxembourg health care system. The reform includes increases in contributions by 0.1 percentage points and the creation of a general spending envelope for hospitals. The authorities are committed to implement this reform immediately. In March 2011, the government has approved the principles of a parametric pension reform and launched a process of consultation of the social partners. The main proposed features include incentives to increase career duration. A reform of long-term care insurance is planned for 2012. The authorities are acutely aware of the challenges that demographic ageing is posing and stand ready to implement further reforms to ensure fiscal sustainability.

**Other structural reform needs are being considered as well.**

The automatic wage indexation remains a much debated subject in Luxembourg. A number of proposals, e.g. excluding certain components from the indexation basket or capping the level of income to be indexed, are being discussed by the social partners.

**The banking sector is recovering in a heterogeneous manner.**

The banking sector in Luxembourg is still adapting to a post-crisis context. While profits rose in 2010, this is almost exclusively due to lower provisioning needs. Revenues on interest rate margins declined in the current low interest rate environment. Balance sheets continue to shrink, mostly as a consequence of reductions in portfolio asset values, reductions in interbank exposures and a decrease in holdings of certain types of assets (e.g., sovereign debt).

From a more structural perspective, while some banks with certain profiles are retreating from the Luxembourg financial center – mostly as a result of restructuring measures imposed by the European Commission on rescued banking groups – large banking groups have taken decisions in favor of the Luxembourg location with its vast experience as a hub for back-office and custodian services to the group. Private banking is also undergoing a transformation, becoming more service oriented and catering increasingly to a more sophisticated clientele.

**Banks have stabilized.**

Solvency, Tier 1 capital and liquidity indicators are traditionally high in Luxembourg, although the picture varies at the micro level. Only 6 percent of banks have a solvency ratio between 8 and 10 percent in 2010 whereas on the other extreme 68 percent of banks have a solvency ratio above 15 percent. The average Tier 1 capital ratio has been 15.3 percent in 2010 and almost 85% of total own funds are core Tier 1 funds. Sovereign exposures to peripheral European countries amount to less than Euro 20 billion and have decreased continuously over the past year – including at the request of the supervisor. Stress tests performed by Fund staff and staff of the Supervisor (CSSF) during the FSAP mission confirm the relative resilience of Luxembourg banks to sovereign stress but also the absence of contagion effects in the Luxembourg banking sector from shocks affecting solvency and liquidity elsewhere.

Macro-stress tests carried out by the Banque centrale du Luxembourg (BCL) demonstrate that, despite differences at the individual bank level, Luxembourg banks are sufficiently capitalized. They show that under the severe scenario of a prolonged recession, the Luxembourg banking sector remains robust. The BCL's liquidity stress tests show that the Luxembourg financial sector remains robust not only in the face of peripheral European sovereign stress, but also to a contemporaneous interbank shock.

The local retail market has remained stable throughout the crisis. While private real estate prices have been high and increased strongly before the crisis, they have remained fairly stable – with slight declines in certain segments – since 2009. Nonetheless, the CSSF is monitoring the situation closely and has intervened to make sure the banks apply sound and prudent lending criteria.

**The Investment Fund industry is very dynamic and balance sheets are recovering.**

The investment fund industry has largely recovered. In March 2011 the net asset value (NAV) of the industry as a whole amounted to Euro 2.2 trillion. This is a result of both revaluation of assets held and new inflows. The number of investment funds has increased by 204 units between end 2009 and end 2010 (from 3463 to 3667). Anecdotal evidence also suggests that funds that used to be offshore before the crisis are now seeking the safety of a regulated product like the UCITS brand and redomicile in Luxembourg. Overall, it seems that the Luxembourg fund industry is exiting the crisis in a relatively unscathed manner – both from a financial stability point of view and with regard to its reputation as a well regulated product.

**Regulatory challenges are being addressed rapidly.**

The authorities have quickly addressed issues of concern raised by the FATF review in February 2010 and the corresponding legislation has passed parliament in November 2010. Also, some of the recommendations from the 2010 FSAP regarding the governance of the CSSF have already been addressed and the corresponding legislation has been adopted or has been introduced into the legislative process.

Draft legislation on a new deposit insurance mechanism is awaiting the finalization of discussions at the European level, before being submitted to parliament. In this context, the BCL has proposed a Financial Stability Fund combining a deposit insurance mechanism and a bank resolution fund. In March 2011, the government decided to increase the capital of the BCL, including for IMF purposes. In an effort to strengthen financial stability further, the BCL and CSSF continue recruiting highly qualified staff.

At the international level both the CSSF and the BCL are engaged in exchange, discussion and analytical work in the new European supervisory infrastructure EBA and ESRB. In addition, exchange of supervisory information and home-host coordination takes place at the level of Supervisory Colleges and Cross Border Stability Groups for all important banking groups with cross border activities.