Luxembourg: Staff Concluding Statement of the 2022 Article IV Mission

March 11, 2022

> A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or ‘mission’), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.
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> The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF’s Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Washington, DC:

Luxembourg weathered the pandemic well and its economy has recovered rapidly, with real GDP surpassing its pre-crisis trend. Yet, inflation is picking up amid labor shortages, housing prices have been growing at a fast pace, and the share of long-term unemployment is rising. While the financial system has been resilient, some structural vulnerabilities persist, such as low profitability. The Russia-Ukraine conflict is expected to weigh on the recovery and poses significant downside risks—uncertainty is high. Direct exposures of Luxembourg’s financial system to Russia and Ukraine are very limited as a share of assets, but the overall impact will depend on the spillovers to global financial conditions and confidence. The moderately accommodative fiscal stance this year and the recently adopted fiscal measures to shield households from rising energy prices are broadly appropriate. Going forward, while remaining flexible to address shocks, additional support should, to the extent possible, be targeted and timebound to promote non-inflationary growth. Close monitoring of emerging risks in the financial sector should continue. Given persistent residential real estate risks, the authorities should consider further tightening of borrower-based limits. To mitigate imbalances in the housing market, efforts to increase supply should be accelerated. Also, further action is needed to address factors that contribute to high demand *pressures, use existing resources more efficiently (e.g., by constructing higher buildings with greater density), and tackle bottlenecks in the construction sector. Policies to support labor market participation, reallocation, and employment of disadvantaged groups should be strengthened. The authorities should continue to adapt their policies to take full advantage of the green transition and digitalization, while minimizing costs, such as carbon leakages.*

Context

Luxembourg's economy has recovered rapidly from the pandemic's impact, with real GDP surpassing its pre-COVID trend. Following a milder-than-expected contraction in 2020, GDP is estimated to have rebounded by 6.9 percent in 2021. Employment and unemployment returned to their pre-pandemic levels amid record high vacancies. Nonetheless, the share of long-term unemployment has been rising, reflecting skills mismatches. Inflation picked up notably, driven mostly by energy prices, triggering automatic wage indexation in October 2021. Core inflation, so far muted, has been rising amid supply bottlenecks and labor shortages. The 2021 fiscal position was better than expected, supported by revenue overperformance. The financial sector has been resilient. Rapidly growing housing prices, for the third consecutive year, raise concerns about affordability, attractiveness for workers, and medium-term financial stability.

Outlook and risks

The war in Ukraine is expected to weigh on the recovery mainly through effects on global financial conditions, confidence, and lower growth of trading partners. Although the magnitude of the impact is difficult to forecast at this stage, staff will revise growth projections down relative to the October 2021 World Economic Outlook, with risks clearly tilted to the downside. Higher energy and commodity prices will fuel inflationary pressure further this year. Elevated demand, rising construction costs, and persistent supply constraints will likely maintain pressure in the housing market. The medium-term outlook, while uncertain, is more positive, and hinges on the authorities acting decisively to address housing imbalances and navigating successfully the green and digital transitions.

Policies

Fiscal

The moderately accommodative stance in 2022 and the recently adopted fiscal measures to shield households from rising energy prices are broadly appropriate. The increase in the cost-of-living allowance and the subsidy to stabilize electricity prices and cover the distribution costs of gas providers will help protect people's purchasing power. Fiscal policy should remain flexible, as the magnitude and impact of various shocks are uncertain. The measures should, to the extent possible, be targeted (to low- and middle-income households) and timebound. Other measures in line with those proposed by the EC could also be considered as needed. Given uncertainty around the duration of the energy price shock, automatic wage indexations could increase inflation persistence and hamper competitiveness, leading to higher unemployment. In close consultation with social partners, the authorities could consider, for example, temporarily limiting the frequency of wage indexation to one per year, while using targeted support to protect the most vulnerable. Additionally, postponing non-urgent public hiring could help relieve pressures in the labor and housing markets. Should the risks from the conflict dissipate, the authorities should resume gradual policy normalization next year to promote non-inflationary growth. On the other hand, if downside risks materialize, additional support measures could be considered.

In parallel, fiscal reforms are needed to deal with potential revenue losses and distributional costs associated with the green and digital transitions. Tax and spending policies should be adjusted in ways that diversify sources of revenue and improve equity, while preserving attractiveness for workers. Risks on the revenue side are non-negligible and stem mainly from changes to international taxation, the impact of carbon taxation, and remote/hybrid work becoming the new norm. Accordingly, reforms should cover property and environmental taxation, the corporate wealth tax, and personal income taxation, in line with past Article IV recommendations. On the expenditure side, it is important to better target social spending (including homebuyers assistance) and further improve the efficiency of public investment. These measures should help rebuild fiscal buffers.

Financial sector

The financial system weathered the pandemic well, but the Russia-Ukraine conflict poses new risks.

· On aggregate, banks remain well capitalized and liquid. Asset quality improved somewhat as the economy rebounded and the pandemic did not result in higher bankruptcies and unemployment. That said, the longer-term pandemic effects are still uncertain, and banks' structurally low profitability—as in other euro area countries—continues to be a source of concern.

· Investment funds benefited from the global risk appetite in 2021. However, global stock markets have been declining since early 2022 and the funds remain vulnerable to further corrections or an abrupt increase in risk premia. The authorities have made progress in enhancing liquidity stress tests, including accounting for second-round effects, and have implemented ESMA guidelines on alternative investment funds.

· The direct exposures of banks and investment funds to Russia and Ukraine are very limited as a share of assets. However, the situation is fluid and the impact of the conflict on the financial sector will mainly depend on spillovers to global financial conditions, in a context where rising inflation could complicate the trade-off between price and financial stability. Continuing close monitoring of evolving risks (including cyber security), coordination between supervisors, and communication with financial sector participants will be essential to mitigate adverse impacts.

With rapidly rising house prices and households' indebtedness, the authorities should consider further tightening of the borrower-based limits. The authorities rightly kept their countercyclical capital buffer unchanged during the pandemic. The introduction of loan-to-value limits (LTV) in January 2021 reduced the LTV ratio. However, the debt-service to income and debt-to-income ratios remain high. Moreover, pressures on the housing market are likely to continue. Therefore, staff suggests introducing debt-service-to-income and debt-to-income limits, clarifying the objectives of the differentiated LTV limits, and accelerating the implementation of the credit registry. Sectoral concentration limits (on real estate loans) could also be considered. For investment funds, the authorities should continue to engage actively in international fora for the design and calibration of a macroprudential toolkit.

Structural

Improving housing affordability and maintaining attractiveness

Actions are urgently needed to reduce pressures in the housing market. In addition to posing medium-term financial stability risks, the rapid pace of housing price growth is affecting affordability, and, if continued, could reduce Luxembourg's attractiveness for workers. Efforts to boost housing supply, including for affordable and social housing, and reduce speculation through higher taxation of unused land and empty dwellings are welcome. However, these measures will take time to materialize and may face implementation challenges. To alleviate the current housing pressures, a multipronged approach is needed:

· Fiscal policy should aim at containing housing demand pressures, for example by better targeting the assistance for homebuyers and reducing expected returns (e.g., by phasing out deductibility of interest payments).

· It is essential to increase efficiency in using existing resources (e.g., constructing higher, ecologically sustainable buildings with greater density). Moreover, there is merit to addressing bottlenecks in the construction sector (including labor shortages, availability of landfills, and streamlining burdensome administrative processes) and strengthening public-private partnerships to enhance the sector's productivity.

· Other measures include encouraging residential mobility (by reducing transaction costs for buyers' main residence, and limiting the eligibility for exemptions from capital gains tax on inherited properties to 1-2 years) and lowering the geographic concentration of demand for housing (e.g., by decentralizing activities to rural and regional development centers, continuing infrastructure development, and promoting remote work).

Benefitting from the green and digital transitions

Achieving the authorities' ambitious greenhouse gas emissions targets requires a careful balancing act. Luxembourg is well positioned to take advantage of the green transition, especially through sustainable finance. However, the transition may be associated with sizable revenue losses (mainly due to large carbon leakages). Thus, the increase in carbon taxation should be gradual, well-communicated, supported by further improvements in public transportation and incentives to promote behavioral change (including for cross-border commuters), and accompanied by compensation for low-income households. The carbon tax should be complemented with a gradual removal of implicit subsidies (e.g., on diesel) and an increase in taxes on non-road carbon emissions and car user fees. Incentives for the transition to greener and more energy-efficient products could be more progressive (increased for lower income), to accelerate behavioral change among this category. Efforts to strengthen resilience to climate change should continue, including by increasing investment in climate adaptation and improving preparedness of the financial sector to deal with transition risks.

Strengthened policies that support labor market participation, reallocation, and employment of disadvantaged groups are needed to mitigate potential adverse impacts on inequality. Luxembourg has been investing significantly in infrastructure, including digital, to boost the economy's potential. That said, digitalization could further increase the polarization of the labor market, inequality, and skills mismatches, with adverse effects on unemployment and labor participation. The authorities are appropriately focusing on reskilling workers with outdated skills and investing in digital education. Programs such as the Future Skills initiative implemented during the pandemic and efforts by the Ministry of Education to enhance digital education are welcome. Existing active labor market policies are also welcome but should increase focus on cross-sector reallocation of unemployed workers through skills development and training programs. Programs could also be further extended to allow for participation by currently employed workers and offering lifelong learning opportunities. The authorities should continue to monitor and identify occupations at risk of obsolescence, with input from the private sector. These efforts should inform adaptation of educational programs to get ahead of trends and avoid large-scale skill mismatches. The efforts should be leveraged to design training programs that help reduce future skill obsolescence of aging workers and improve labor participation of the older population. There is also merit in reducing incentives for early retirement. Improvements in education should be accompanied by enhanced vocational training and apprenticeship programs to increase worker productivity while better matching job seekers with job opportunities.

The IMF team would like to thank Luxembourg's authorities and other interlocutors for constructive and insightful discussions.

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