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On behalf of the Luxembourg authorities, we thank the staff for the constructive and fruitful discussions during the 2009 Article IV consultation mission to Luxembourg. The current global environment is challenging for many countries. Luxembourg is no exception. It is particularly vulnerable because of its large financial sector and strong reliance on exports.

The Luxembourg economy is relatively well-prepared to confront the current downturn. The general government budget recorded surpluses in 2005—2008 and the central government and social security have accumulated sizeable reserves. In 2008, at 14.7 percent of GDP, public debt remains low by international standards. Consequently, there is fiscal space to support the economy in this challenging environment.

At the current juncture, the authorities are focusing their efforts on ensuring the soundness of the financial sector, and launching important infrastructure projects so as to mitigate the adverse effects of the downturn on economic activity and employment.

Economic developments and outlook

According to the latest estimates and forecasts published on May 18, Luxembourg experienced negative GDP growth in 2008 (-0.9 percent). In 2009, GDP is expected to contract by 4 percent. For 2010, the Luxembourg statistical office (Statec) projects a moderate resumption of economic growth (1.0 percent). However, risks to this outlook remain skewed to the downside.

In 2008, employment growth held strong at 4.7 percent and even in 2009, it is expected to remain positive at 1 percent. This may be related to effects of labor hoarding by firms due to a scarcity of skilled labor in Luxembourg. Nevertheless, the openness of the Luxembourg economy as evidenced by gross exports, which account for 180 percent of GDP, leaves the country vulnerable to a drop in trade in goods and services. While domestic demand is still strong, the sectors that are focused on exports suffer considerably. This affects mainly the manufacturing and services sectors, including the steel industry, automotive supplies, the plastic industry and metal construction. The construction sector is somewhat sheltered by the infrastructure projects that the government has implemented in the context of its stimulus package.

In order to counter these effects and help firms overcome the downturn while maintaining their human capital, the government has expanded and relaxed the partial unemployment scheme. Under this scheme, the government subsidizes wages for enterprises which temporarily reduce their activity level. While in "normal" times, before the downturn, an average of three firms was participating in the scheme at a given point in time, in March 2009 participation had risen to 114 firms, covering about 9000 workers. The government is considering to expand this scheme further.

The financial sector in Luxembourg is dominated by foreign-owned banks of which a large number are subsidiaries. The banking sector has done fairly well during most of 2008, as interest income rose because of high credit spreads. The balance sheets of banks peaked in October 2008 and by March 2009 it had declined by roughly 5 percent. However, most of the decline in activity has taken place in off-balance sheet activities consisting mostly of guarantees and other commitments.

Nevertheless, besides the two large banks, Fortis and Dexia, where events in the group forced the government – in close coordination with the authorities in the neighboring countries – to step in to protect the domestic subsidiaries, the sector has remained quite stable. By March 2009, employment in the banking sector had somewhat declined.

During the past few decades, developments in international financial markets have shaped growth in Luxembourg. Therefore, any deleveraging in the global financial industry impacts growth in Luxembourg's financial sector. In the past, the Luxembourg authorities have regularly adjusted the legal framework so as to create favorable business conditions for financial players. As confirmed by international organizations, great care has been taken to put in place sound financial regulation in line with international standards and promoting financial stability. The so-called Luxembourg "business model" provides a solid base for further adjustments in a post-crisis environment.

The diversity of the Luxembourg financial sector adds to its strength. Also, the sophisticated and extensive variety of services ranging from banking to asset management, insurance and re-insurance business and covering securitization activities, as well as extensive legal, auditing and IT expertise will ensure that Luxembourg maintains its place among the top international financial centers even in the future.

Apart from the financial sector, the authorities are always looking for niches to attract new industries to Luxembourg. The recent establishment by major players in the ICT and e-commerce field of their European headquarters in Luxembourg is an example of the authorities' forward-looking policies. The authorities are also working on several action plans, including logistics and related services, biotechnology and clean energy. These action plans encompass investments in infrastructure, research and capacity building measures.

Financial sector issues

For many decades now, Luxembourg has been a well-established financial center with close links to other financial centers within and outside the European Union. Asset management, particularly private banking and investment funds administration, has been a key activity of the financial center of Luxembourg. Therefore, it is not surprising that the Luxembourg establishments of cross-border banking groups have become an important source of funding for their groups.
In October 2008, the law of the Banque centrale du Luxembourg (BCL) was amended, entrusting the BCL with the explicit responsibility of liquidity supervision of markets and market operators and with the possibility to provide emergency liquidity assistance. The BCL has recently issued a regulation that sets the framework for its liquidity supervision in line with internationally recognized rules and standards. The Commission de Surveillance du Secteur Financier (CSSF) is focusing on the supervision of the liquidity of individual banks. Currently, discussions are taking place between the two institutions to organize and coordinate their work in the area of liquidity supervision. The new legal framework, therefore, set up the foundations of a framework for liquidity surveillance of markets and market operators that takes on board the lessons from the current crisis, in particular the paramount importance of liquidity risk for financial stability.

Banks in Luxembourg continue to be well capitalized. In most cases, Luxembourg subsidiaries are better capitalized than their parent banks. While welcoming the use of leverage ratios as an additional indicator, the authorities note that leverage ratios have to be used with caution as their usefulness strongly depends on the business model of banks and the kind of instruments they hold (e.g. covered bonds have high leverage but very low risk).

The money market funds (MMF) segment has been fairly resilient during the past several months. The turbulence following the Lehman bankruptcy triggered some redemptive pressures which have been accommodated by the sponsoring banks. The authorities do not see a need for issuing a general guarantee for MMFs (like the one issued in the United States in autumn 2008), since the latter are being sponsored by banks, which in turn have access to the liquidity facilities of the ESCB. The Luxembourg authorities would welcome a common European definition of MMFs as well as increased transparency requirements for MMFs.

The mandatory private deposit insurance scheme in Luxembourg has proven its effectiveness following the failure of the Luxembourg subsidiaries of the Icelandic banks. Even though the system is funded ex-post, banks have built up provisions amounting to Euro 800 million. In order to foster the depositors' confidence in the financial sector and given the recent increase of the covered amount from euros 20,000 to 100,000, an in-depth revision of the deposit guarantee scheme is under way. The main features of the revision will be to turn the scheme into a publicly-run system, to introduce ex ante funding and to reduce considerably the payout period.

The Luxembourg supervisory authorities have comprehensive experience of close cooperation with home supervisors through regular bilateral and multilateral meetings. Recently, this cooperation and information exchange with supervisors from other countries (EU Member states and other countries) has intensified. The supervisory authorities consider that colleges are a valuable tool for promoting supervisory cooperation and welcome the changes in EU legislation that make the setting up of colleges a legal obligation in the banking and insurance sectors.

In the context of recent international developments, in March 2009, the government decided to adopt the OECD standards for exchange of information on request when concluding double taxation agreements.

During the Article IV consultation mission, the authorities formally requested an update of the 2002 FSAP exercise.

Fiscal policies

After several years of fiscal surpluses, 2009 will mark a turning point in this respect. The stimulus package that the authorities are implementing along with declining revenues will result in a deficit which, according to the latest Statec forecast, could reach 2.3 percent of GDP in 2009. The difference between the staff projection of 3.2 percent of GDP and the authorities' projection is mainly because of the different growth assumptions and their impact on revenues. On the expenditure side, social expenditures will weigh heavily on the budget. The lagged impact of the business cycle on certain taxes, notably corporate income taxes, will continue to exert pressure on public finances in 2010 and 2011.

The discretionary stimulus measures that will be implemented during 2009 and 2010 are expected to amount to 2.4 percent of GDP. They focus mainly on employment preservation, income redistribution, infrastructure investments, subsidies for clean energy and energy preservation and the promotion of research. However, due to large automatic stabilizers, the total budgetary support to the economy is even higher. The authorities are nevertheless proceeding carefully so that the country's sound fiscal position is not jeopardized in the medium term.

The Luxembourg social security system provides universal coverage and generous benefits. At the current juncture, it contributes significantly to offset the adverse impact of the downturn in living standards and social cohesion. Due to the strong economic and employment growth during the past couple of decades, the financial position of the social security system is sound in the short to medium-term. However, with unchanged policies and on the basis of prudent assumptions regarding future economic and employment growth, the medium to long-term sustainability of the social security system is not ensured. The authorities are fully aware of the sustainability risk and are engaged in a dialogue with social partners in order to identify possible policy adjustments to improve and ensure the sustainability of the system.