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IMF Executive Board Concludes 2009 Article IV Consultation with Luxembourg

On May, 22, 2009 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Luxembourg.¹

Background

Ongoing financial turmoil and global recession pose daunting challenges to Luxembourg's small open economy. The financial sector—hosting a large number of foreign-owned subsidiary banks, Europe's largest investment fund industry and second largest money market industry—is fully exposed to the turmoil. Besides financial service exports, the contraction in European demand is also weighing heavily on the economy's other export sectors. GDP declined by almost 1 percent in 2008, while reduced demand pressures and the easing of commodity import prices sharply reduced inflation.

The recession is expected to deepen this year, despite some cushioning from substantial and well-designed fiscal stimulus. Real GDP growth is forecast to decline by another 5¼ percent, amid a further contraction in the financial sector and continued weakness in external demand. Meanwhile, the contraction in output, the full functioning of the automatic stabilizers, combined with fiscal stimulus measures are projected to result in a budget deficit this year marginally in excess of the Maastricht ceiling. Nevertheless, the increase in the near-term financing requirement is not expected to call

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.

into question fiscal sustainability, given low public sector indebtedness. Price pressures should remain subdued throughout the year.

In the current environment, the large size of the financial sector, dominant foreign ownership, and close integration of local subsidiaries with their mostly European parent groups have implications for financial stability. High intra-group exposures and over-reliance on wholesale funding create liquidity risks that would materialize if the health of the European banking sector were to deteriorate. Banks' capital—though still comfortable—is thinning, while leverage remains relatively high. At the same time, there are systemic risks emanating from Luxembourg to the euro area, as a result of the large volume of money market and other short-term financing provided by the financial center to the European banking sector.

Executive Board Assessment

While Luxembourg's economy has outperformed most of the euro area in the recent past, it is now heavily exposed to the global crisis given its large, internationally-integrated financial sector and strong reliance on exports. With weakening activity in the financial system and falling export demand, output is expected to decline in excess of the euro area average in 2009, and changes to the global and European financial architecture could lower potential growth over the longer term.

Executive Directors emphasized that maintaining financial stability is a precondition for continued economic success, and welcomed the authorities' efforts to ensure the soundness of the financial sector. They supported the recent successful interventions in the banking sector, including the rescue of two major banks, and the initiative to improve banks' liquidity management. Strong cooperation between the central bank and the regulator will be vital for success.

Many Directors stressed the importance of further enhancing crisis preparedness. In light of the large size of the financial sector and its systemic importance, they suggested a multilateral and cooperative approach. This would require the resolution of home-host country banking issues, including through a proactive pursuit of burden-sharing arrangements, that should also cover the large money market fund industry as well. In this context, the need for a liquidity facility could be explored. A number of other Directors were, however, of the view that current arrangements in the European Union provide an adequate framework for cross-border cooperation on crisis management and resolution of financial stability issues.

Directors supported the authorities' proposed regulatory and supervisory actions to improve financial stability by strengthening the resilience of individual institutions, and welcomed the authorities' request for an FSAP update. While noting that system-wide capital levels appear adequate, they called for a further strengthening of the regulatory regime, a tightening of capital requirements, and the introduction of binding limits on leverage. However, Directors cautioned that such measures need to be phased in carefully and coordinated internationally, especially at the level of the European Union.

Looking ahead, Directors noted that the financial sector will need to adjust to the new financial architecture that emerges in the aftermath of the crisis. In this context, they welcomed the authorities' ongoing efforts to streamline the financial services industry as well as to diversify the services sector.

Directors noted that Luxembourg's public finances are well positioned to weather the recession. They considered the size and scope of the authorities' fiscal stimulus package to be appropriate, and supported their intention to allow the automatic stabilizers to function fully. Despite recent bank rescue efforts, the public debt stock remains low by international standards and provides ample scope to finance budgetary pressures over the near term. At the same time, Directors welcomed the authorities' recognition of the need, once recovery begins, for strong efforts to enhance medium-term fiscal sustainability, as expenditures are rising and the evolution of medium-term fiscal revenues is uncertain. Directors therefore advised the authorities to reconsider the planned return to full indexation of wages and social benefits in 2010, as this could exacerbate budgetary pressures, and also hamper efforts to improve competitiveness. Directors also stressed that far-reaching reforms of the public, pay-as-you-go pension system remain overdue, and should be pursued with priority, given that substantial funding gaps continue to threaten its long-term viability.

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Luxembourg: Selected Economic Indicators, 2005-09

	2005	2006	2007	2008	2009 1/ Proj.
Real economy	(Change in percent, unless otherwise indicated)				
Real GDP	5.2	6.4	5.2	-0.9	-5.3
Unemployment (as a percent of total labor force)	4.3	4.5	4.4	4.0	6.9
Resident employment	198.7	203.2	207.1	211.8	208.6
Total employment	307.8	319.0	333.2	348.7	341.4
CPI (harmonized), p.a.	3.8	3.0	2.7	4.1	-0.4
Gross fixed investment (in percent of GDP)	3.4	1.0	11.8	1.7	0.4
Public finances	(Percent of GDP)				
General government revenues	41.6	39.9	40.8	43.3	43.5
General government expenditures	41.6	38.6	37.2	40.7	46.8
General government balance	0.0	1.4	3.6	2.6	-3.3
General government gross debt	6.1	6.7	6.9	14.8	18.9
Balance of payments					
Current account balance	11.0	10.4	9.8	5.5	5.1
Balance of trade in goods and services	32.0	38.4	45.9	41.1	37.4
Factor income balance	-17.9	-24.8	-31.4	-30.1	-27.1
Transfer balance	-3.1	-3.1	-4.7	-5.5	-5.2
Exchange rates					
Exchange rate regime		Member of the euro area			
U.S. dollar per euro	1.25	1.26	1.37	1.47	...
Nominal effective rate (2000=100)	104.9	106.3	108.2	107.9	
Real effective rate (CPI based; 2000=100)	106.7	108.6	110.9	110.3	

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

1/ Staff projections, if not otherwise indicated.