Luxembourg: Staff Concluding Statement of the 2020 Article IV Mission

February 14, 2020

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 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.

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.

An International Monetary Fund (IMF) mission, led by Mr. Emil Stavrev, visited Luxembourg during February 3-14 to conduct the 2020 Article IV consultation.

Growth, albeit moderating somewhat, has remained robust, supported by domestic demand. The outlook is favorable but there are downside risks, mostly external, such as rising protectionism, a sharp increase in risk premia, and changes in global corporate taxation.

Luxembourg has space to fund the envisaged public spending increase and the ambitious tax reform package which focuses on key policy priorities. We encourage the authorities to: (i) maintain a prudent fiscal policy and preserve comfortable fiscal buffers, given non-negligible fiscal risks, notably from global tax reforms and (ii) explore contingency plans to diversify revenues and improve public investment efficiency to help mitigate the fiscal risks.

Further strengthening the resilience of the financial sector in line with the 2017 Financial Stability Assessment Program (FSAP) recommendations is welcome. These efforts should continue, including the activation of borrower-based limits to contain the risks' buildup in the real estate market.

Finally, to increase housing supply and reduce structural unemployment, the authorities should, among others, modernize the rigid urban zoning and planning as well as administrative rules, and enhance incentives for the most vulnerable to succeed in the labor market, respectively.

Context

Thanks to sound economic policies and supportive external environment Luxembourg has achieved strong economic performance. The economy has been expanding rapidly in recent years, translating into solid employment gains and a significant decline in unemployment. After a robust growth of 3.1 percent in 2018, activity is estimated to have slowed to 2.6 percent in 2019, and the labor market is cooling off somewhat. However, frequent and substantial GDP revisions, as illustrated by the recent upward growth revisions, complicate economic assessment. While the recent addition to the staff in national accounts statistics at STATEC is welcome, substantially more resources should be devoted to that end in light of the increasing complexity of the economy. Thanks to prudent fiscal management, Luxembourg has maintained gross public debt low and has kept its structural fiscal balance well above the Medium-Term Objective (MTO). Strong commitment to comply with international anti-tax avoidance and transparency initiatives has helped bolster the country's reputation.

The outlook is favorable but there are downside risks. Medium-term GDP growth is projected to remain strong, underpinned by robust domestic demand and net export of services but there are downside risks. Rising protectionism and a sharp increase in risk premia could increase financial volatility and impact the financial sector's profitability. Changes in the international taxation landscape could pose non-negligible fiscal revenue risks. Domestically, continued high growth of real estate prices could further reduce housing affordability and exacerbate household indebtedness.

Safeguarding fiscal soundness

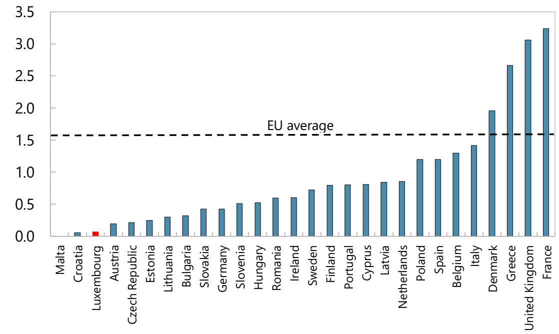
The government adopted another expansionary budget for 2020 and plans to implement an ambitious tax reform package, focusing on key policy priorities. The 2020 budget foresees some fiscal impulse, including permanent spending increases on wages. Over the medium term, in addition to stepping up public investment, the government envisages a welcome tax reform package, consisting of: (i) generalizing individual taxation to enhance labor market participation; (ii) reforming environmental taxation to support the government's climate change agenda; and (iii) modernizing housing taxation to support housing supply. The government is pursuing a holistic approach with gradual implementation of the intended reforms.

While Luxembourg has space to fund these plans, it should preserve comfortable buffers given fiscal risks from the ongoing global tax reforms. Further steps taken in 2019 to comply with international anti-tax-avoidance and transparency initiatives, notably the transposition of the EU Anti-Tax Avoidance Directive II into national law, are welcome and could strengthen the tax base. While corporate income tax revenues have increased, partly due to temporary factors, there are signs that these initiatives—coupled with revisions in the U.S. tax system—are affecting large multinational enterprises (MNEs) in a way that may reduce tax revenues in Luxembourg.

Also, fundamental changes in international taxation currently under discussion would, among others, give greater taxing rights to jurisdictions where MNEs' customers are located and, if agreed, could lead to a non-negligible tax revenue loss. The potentially large fiscal risks from the intended domestic tax reforms should be carefully considered. Accordingly, the government should continue its prudent fiscal policy and keep comfortable buffers above the MTO, targeting an overall structural surplus of around 1 percent of GDP.

Furthermore, the government should explore options to diversify revenues and improve public investment efficiency. In particular, it could increase the low transport taxes, for example by introducing one-off car registration fees, remove the preferential VAT treatment of heating energy, while protecting the most vulnerable, and modernize the outdated property valuation. Also, public investment management should be improved by strengthening the budgetary framework (such as introducing a spending review mechanism) and governance arrangements (notably, conducting independent and systematic ex-post project evaluations).

Revenue from Property Tax for Selected EU Countries
(Percent of GDP, 2018)



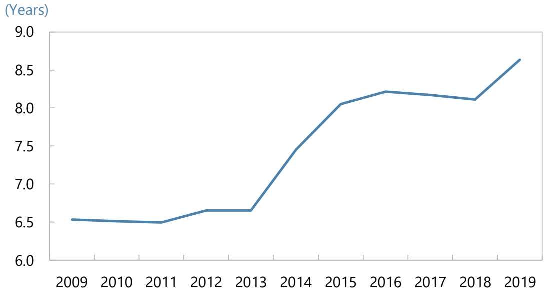
Source: Eurostat.

Preserving financial sector's resilience

Overall, the financial sector has coped well with the low-for-long interest rates. On aggregate, *banks'* profitability has remained comfortable, but there is a wide variation across the different segments, with those focused on commission-based activities generally faring better. Overall, *investment funds* posted a strong performance though search for yield has continued. The *life insurance sector* has also performed well, reflecting a prudent business model and increased activity, partly due to Brexit.

The financial sector appears resilient, but structural profitability issues and balance sheet vulnerabilities arising from greater risk-taking in some segments should continue to be closely monitored. Recent top-down stress tests by the supervisory authorities indicate that: (i) *banks* have generally sufficient capital and liquidity buffers to withstand severe macro/liquidity shocks; (ii) *bond funds* could meet large redemptions under stressed market conditions within a reasonable timeframe; and iii) *insurance companies* would generally remain solvent in the face of severe shocks. Nonetheless, the existing structural profitability

Residual Maturity of Non-MMF Funds' Debt Securities
(Years)



Notes: The chart shows yearly average figures. Bond securities include perpetual bonds, which are assumed to have a residual maturity of 100 years.
Sources: BCL; and IMF staff calculations.

issues in certain segments of the banking sector (such as high reliance on capital market developments and relatively low cost-efficiency) as well as the build-up of balance-sheet vulnerabilities (such as larger liquidity mismatches in the fund sector and greater reinvestment risk for life-insurance companies), partly due to search-for-yield, warrant continued monitoring.

Building on their noticeable progress, the authorities should continue to follow up on the 2017 FSAP recommendations to further strengthen the resilience of the financial sector.

- *Banks*. The completion of resolution planning for most less systemic institutions (LSIs) is welcome. Efforts to strengthen the supervision of the banks' large cross-border exposures and the review of the waivers to large exposure limits for intra-group transactions should continue. A high level of engagement with supervisors of parent/group of Luxembourg's LSIs located outside the euro area should be maintained.

- *Investment funds*. The Commission de Surveillance du Secteur Financier's (CSSF) active involvement in EU-level discussions to strengthen the sector's supervision/regulation, including on liquidity stress test guidance by the European Securities and Market Authority (ESMA), is welcome. Given the sector's prominence and its high connections with the rest of the financial system, the authorities involved in macroprudential policy should take a lead role in relevant international fora on: (i) a guidance on liquidity management tools; and (ii) a design of macroprudential toolkit for investment funds. The progress on a risk dashboard, closing important data gaps, notably for asset liquidity and average maturity, and strengthening liquidity stress testing capacity is welcome. These efforts should continue, including by building system-wide indicators for leverage and asset quality, and developing methodologies for system-wide liquidity stress testing.

- *Macroprudential policy settings and governance*. The adoption of the borrower-based limits law, the publication of the substance of the macro-financial risk analysis, and the initiation of preparatory work for the development of a national credit register are welcome. The authorities appropriately increased the counter-cyclical capital buffer. However, this does not fully address the growing household balance-sheet vulnerabilities, calling for the activation of borrower-based limits. On governance, the de-facto lead role of the Banque Centrale du Luxembourg (BCL) in financial stability analysis as well as the operational independence of the CSSF and the CAA should be enshrined in legislation.

- *Money laundering and terrorist financing (ML/TF)*. The 5th EU Anti-Money Laundering Directive is expected to be fully transposed into national law this spring, including setting up registries for ultimate beneficiary owners of trusts and fiduciaries as well as bank accounts. Welcome efforts by the CSSF to address ML/TF risks in the financial system, including the implementation of the 2019 European Banking Authority peer review's recommendations, the issuance of a circular on determining beneficial ownership, and the conduct of sub-sectoral risk assessment, should continue. Following on the recommendations of the National

Risk Assessment, vertical risk assessment targeting in particular virtual assets and terrorism financing will be carried out this year.

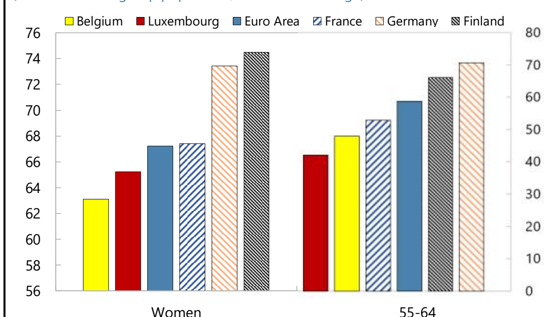
Boosting economy's potential and making growth more inclusive

To boost the economy's potential and make growth more inclusive, further efforts are needed to address Luxembourg's main structural gaps:

- *Address structural supply constraints and improve inclusiveness in the housing market.* Real house prices continued rising rapidly in 2019, further weighing notably on affordability. To expand housing supply, the authorities should modernize the rigid urban zoning and planning, and administrative rules. They should also move forward with amending the law on communal development that would help increase the supply of buildable land. The intention to adopt the *Pacte Logement 2.0* by end-2020 is welcome. This would help enhance the supply of affordable housing, including by linking subsidies allocated to municipalities to the amount of social housing built. Establishing a national register for social housing is important to support these efforts. Finally, the sizeable tax incentives that support housing demand should be gradually phased out while sheltering the vulnerable groups.

- *Reduce structural unemployment.* Despite strong job creation, structural unemployment remains relatively high, and the vulnerable groups (women, older workers, and low-skilled) continue to face difficulty succeeding in the labor market. Further efforts to address disincentives from the tax/benefit system would help raise participation rate of these groups. For example, the intended reform of individual taxation would help make the tax system more gender-neutral by reducing the marginal tax rate applied to the secondary earners' income, often women. Also, further reducing the generosity of the welfare system by phasing out early retirement benefits—combined with the welcome planned introduction of the Occupational Inclusion Assistance—would increase elderly labor market participation. Finally, the newly implemented *Revenu d'Inclusion Sociale* would alleviate some of the work disincentives, especially for low-skilled and older workers. Building on recent initiatives such as the Digital Skills Bridge program, Luxembourg should continue to explore future skill needs, including through regular skill foresight exercises.

Labor Force Participation
(Percent of total group population, 2013-2018 average)



Source: Eurostat.

The mission thanks the authorities and other interlocutors for constructive discussions.