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LUXEMBOURG

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2022 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT FOR LUXEMBOURG

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2022 Article IV consultation with Luxembourg, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on March 11, 2022, with the officials of Luxembourg on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 12, 2022.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2022 Article IV Consultation with Luxembourg

FOR IMMEDIATE RELEASE

WASHINGTON, DC – June 1, 2022: On May 27, 2022, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Luxembourg and endorsed the staff appraisal without a meeting on a lapse-of-time basis.[1]

Luxembourg recovered rapidly from the pandemic and its financial sector remained resilient. More recently, however, the war in Ukraine, rising inflationary pressures, and shifts in monetary policy globally have started to weigh on confidence and increased financial markets volatility. Growth is expected to slow to less than 2 percent this year, while inflation is likely to soar due to high energy and food prices and rising wages. The labor market remains tight and housing imbalances continue. To shield households' purchasing power and support affected firms, the government announced a fiscal package of more than 2 percent of GDP in March.

The outlook is highly uncertain, and near-term risks are tilted to the downside. While direct exposures to Russia and Ukraine are limited, Luxembourg's economic prospects depend on the reverberations of the war in Ukraine and monetary policy normalization throughout the globe. Domestically, persistent supply bottlenecks, including labor shortages, and a sharp drop in consumer confidence could weigh on prospects. Changes in international taxation, carbon taxation, and remote work could lower fiscal revenues in the medium term.

Executive Board Assessment[2]

Given the ample fiscal space and prevalence of downside risks, maintaining an accommodative fiscal stance this year is broadly appropriate. The authorities' measures to support households and affected firms, promote the green transition, and the tripartite decision to limit automatic wage indexation to once per year for 2022–2023 are welcome. Going forward, fiscal policy should remain nimble and strike the right balance between safeguarding the recovery and avoiding to fuel imbalances in a context of constrained supply. Additional support, if any, should be targeted and timebound and price distortions should be avoided. Looking beyond the war, the authorities should continue to gradually normalize fiscal policy

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[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.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

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and accelerate reforms to diversify revenues and increase equity through better targeting of tax expenditures and social transfers.

Given that direct exposures to Russia and Ukraine are limited, financial stability risks are broadly manageable. However, it is important to continue to closely monitor the indirect effects of the pandemic and the war and further enhance coordination with other jurisdictions to manage risks from cross-border exposures. At the same time, the structurally-weak profitability of the banking sector should be addressed by incentivizing diversification of activity and mutualization of compliance costs. Recent progress in strengthening the oversight of the investment fund sector, including stress testing methodologies, is welcome. The authorities should continue to engage actively in international fora on the design and calibration of a macroprudential toolkit for investment funds. Building on recent progress, Luxembourg should further strengthen the AML/CFT framework.

Addressing housing is key for social cohesion and the country's attractiveness and requires decisive actions on both the demand and supply side. The increased focus on boosting supply of affordable and social housing, and plans to tax unused lands and vacant dwellings are welcome. In complement, it is essential to build higher, denser, and with reduced costs, and address supply bottlenecks. Measures to boost productivity in the construction sector and property taxation reforms to foster mobility are also needed. Given supply constraints, the authorities should refrain from demand supportive measures and better target housing assistance. The authorities should also continue to closely monitor real estate risks in the financial sector and consider macroprudential measures to curb those risks.

The authorities have ambitious targets to reduce greenhouse gas emissions and a comprehensive strategy to deal with climate change. The increase in carbon taxation should be gradual, well-timed, and clearly-communicated, supported by further improvements in public transportation and compensation for low-income households. The authorities should gradually remove implicit subsidies, raise taxes on non-road carbon emissions and car user fees, and further increase the progressivity of incentives to transition to greener economy. To enhance resilience to climate shocks, the authorities should boost infrastructure investment and further improve the financial sector's preparedness to deal with climate risks.

The authorities' active labor market policies to reduce skills mismatches and improve employability of jobseekers, including through upskilling and reskilling programs are welcome. They should extend those measures to existing workers and promote within and inter sectoral reallocation, and enhance vocational training and apprenticeship programs in close coordination with the private sector. Finally, incentives for early retirement should be reduced to improve the labor market participation of seniors.

It is expected that the next Article IV consultation with Luxembourg will be held on the standard 12-month cycle.

Table 1. Luxembourg: Selected Economic Indicators, 2020-23

		Est.	Proj.	
	2020	2021	2022	2023
Real economy (percent change)				
GDP	-1.8	6.9	1.8	2.1
Domestic demand	-2.3	7.3	3.7	3.2
Foreign balance 1/	-0.1	2.1	-0.9	-0.1
Labor market (thousands, unless noted otherwise)				
Unemployed	18.7	17.1	15.3	15.5
(Percent of labor force)	6.4	5.7	5.0	5.0
Resident employment	275.8	282.1	289.9	295.7
Cross border workers (net)	196.4	204.6	211.4	217.1
Total employment	472.2	486.7	501.3	512.8
(Percent change)	1.9	3.1	3.0	2.3
Prices and costs (percent change)				
GDP deflator	4.3	6.8	3.4	2.3
CPI (harmonized)	0.0	3.5	5.6	2.0
CPI core (harmonized)	1.2	1.5	3.0	2.4
CPI (national definition)	0.8	2.5	4.5	2.3
Public finances (percent of GDP)				
General government revenues	43.7	43.2	42.9	43.5
General government expenditures	47.2	42.3	44.0	43.9
General government balance	-3.4	0.9	-1.2	-0.4
General government structural balance	-2.0	0.7	-0.7	-0.3
General government gross debt	24.8	24.4	25.7	26.4

Balance of payments (percent of GDP)				
Current account	4.1	4.8	4.0	4.1
Balance on goods	3.2	1.1	0.3	0.5
Balance on services	34.0	34.1	31.9	31.3
Net factor income	-32.8	-30.2	-28.4	-27.8
Balance on current transfers	-0.3	-0.1	0.2	0.2
Exchange rates, period averages				
U.S. dollars per euro	1.14	1.18	...	...
Nominal effective rate (2010=100)	103.21	103.75	...	...
Real effective rate (CPI based; 2010=100)	100.87	100.92	...	...
Credit growth (percent change)				
Credit to nonfinancial private sector 2/	5.0	5.3	5.7	4.9
Potential output and output gap				
Output gap (percent deviation from potential)	-3.0	0.5	-0.2	-0.2
Potential output growth (percent)	2.3	3.2	2.5	2.0

Sources: Luxembourg authorities and IMF staff estimates.

1/ Percentage point contribution to GDP growth.

2/ Including a reclassification of investment companies from financial to non-financial institutions.

LUXEMBOURG

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

May 12, 2022

KEY ISSUES

Context. Real GDP surpassed its pre-pandemic trend in early 2021, and the labor market is tight. Inflation is increasing, mainly driven by energy prices, but core inflation is also edging up. The fiscal position strengthened and the financial sector has remained resilient. Rapidly growing housing prices raise concerns about affordability and could pose risks for financial stability and the country's attractiveness in the medium term. Following the outbreak of war in Ukraine, inflation pressures have intensified and financial market volatility has risen.

Outlook. The war in Ukraine is weighing on the recovery. Real GDP is projected to average 2 percent in 2022-23, supported by private consumption and accommodative fiscal policy. Both headline and core inflation will increase sharply in 2022 and are likely to remain above 2 percent in 2023. Pressures in the labor and housing markets are expected to continue. Uncertainty is high and risks, stemming from the war, a sharp tightening of global financial conditions, and the evolution of the pandemic are to the downside. Over the medium term, addressing structural imbalances in the housing market and challenges posed by the digitalization and green transitions, including rising inequality (from a comparatively-low level) would be key to maintaining Luxembourg's attractiveness.

Policy recommendations

Fiscal policy. The 2022 stance is broadly appropriate. Maintain flexibility. Support measures, if any, should be targeted and time- bound, given the tight labor and housing markets and revenue risks, including from international taxation. Consider postponing non-urgent public job hiring, given the tight labor and housing markets. Resume gradual normalization to support non-inflationary growth once risks dissipate. Accelerate reforms to diversify revenue and increase equity, through better targeting of tax expenditures and social transfers and reforms to environmental taxation.

Financial sector policies. Continue close monitoring of evolving risks (including cyber security) and risks related to structural profitability in the banking sector. Special attention should be devoted to cross-border exposures and close coordination with other jurisdictions. Keep countercyclical capital buffers unchanged for now and consider

introducing limits on debt-service and debt-to-income ratios, and concentration limits on real estate exposures. For investment funds, continue strengthening risk-based supervision and engaging in international fora to develop the regulatory and macroprudential framework.

Housing policy. Pursue a multipronged approach by reducing supply rigidities using existing resources more efficiently, addressing supply bottlenecks and enhancing productivity in the construction sector, and containing demand pressure (especially by better targeting help-to-buy policies). In parallel, continue supporting overburdened tenants and increasing the supply of social and affordable rental housing.

Climate change. Gradually increase the carbon tax together with further progress on public infrastructure, including transportation and e-mobility. Recycle revenue to promote behavioral change for cross-border commuters. Enhance carbon price signaling and continue compensating low-income households. Strengthen resilience to extreme climate risk events. Accelerate implementation of environmental, social, and governance (ESG) taxonomies and disclosure requirements and strengthen climate stress-test capacity.

Digitalization and the labor market. Given that digitalization could increase the polarization of the labor market and skill mismatches, strengthen policies that support labor market participation, reallocation, and employment of disadvantaged groups. Continue to implement active labor market policies, while increasing focus on cross-sector reallocation of unemployed workers. Extend existing programs to allow participation by currently-employed workers and offer lifelong learning opportunities. Continue to adapt education and vocational training programs to future market needs in collaboration with the private sector.

Approved By
Ms. Papi (EUR), Ms. Tamirisa (SPR)

Discussions were held during February 28–March 11, 2022. The team comprised Messrs. E. Stavrev (head), T. Jardak, S. Ayerst, and W. Fonteyne, and was assisted by Ms. K. Cerrato and Ms. P. Castillo (all EUR). Mr. M. Scholer (OED) joined the discussions. The mission met with Minister of Finance Backes, Governor Reinesch, other officials, and representatives from the private sector and civil society.

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