

Luxembourg OECD Economic Survey 2010

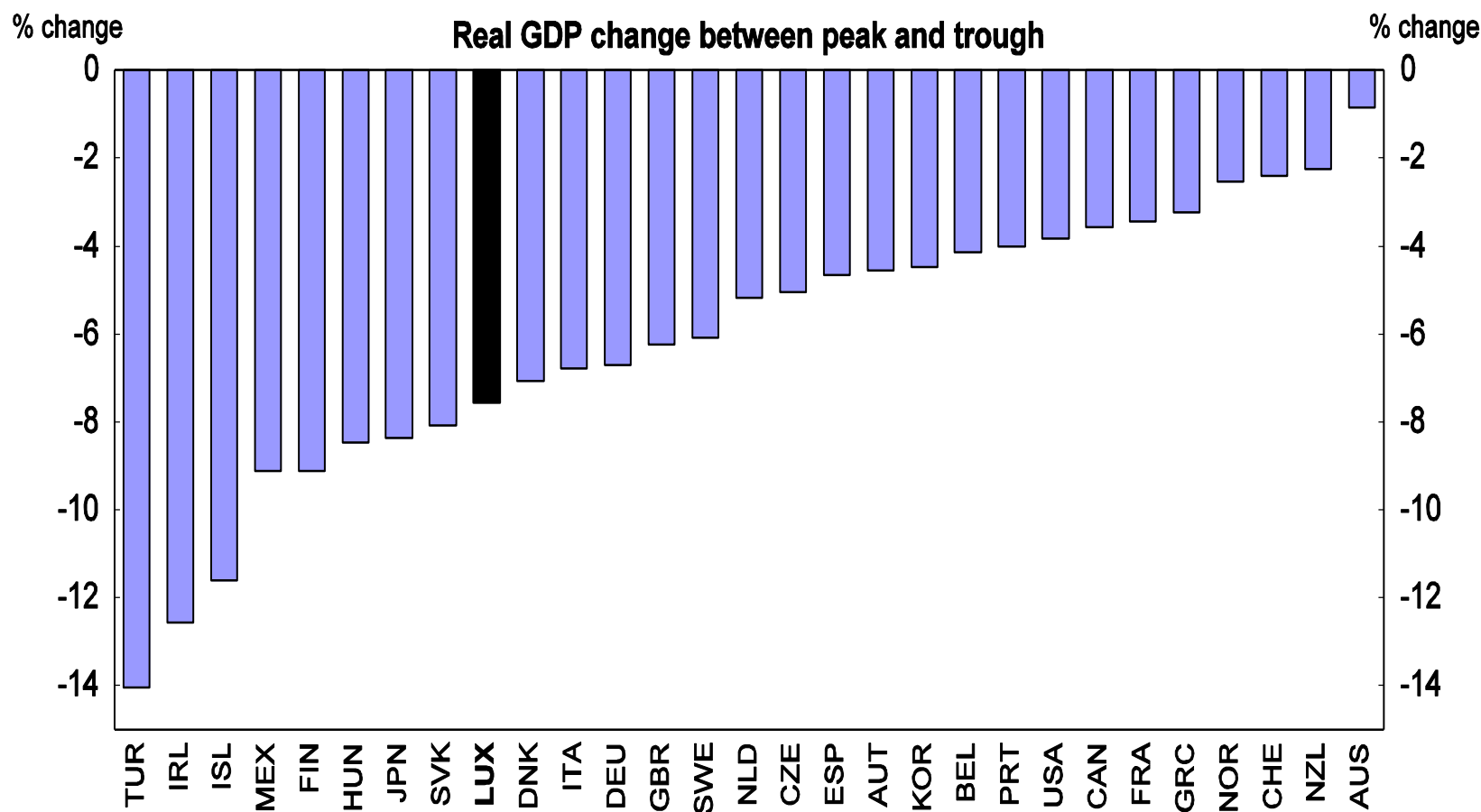
Presentation by OECD staff
10 May 2010

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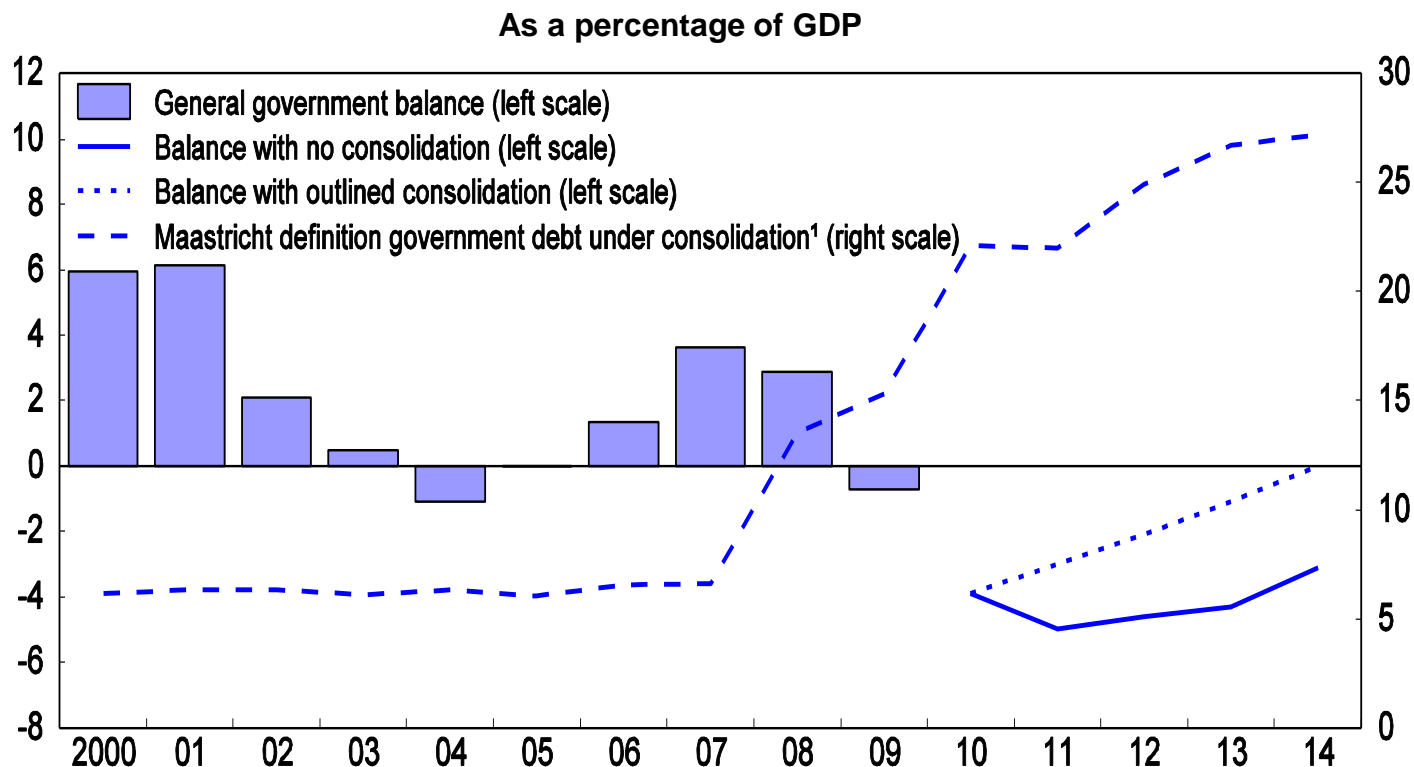
Outline

1. Economic Outlook and Challenges
2. Financial Sector
3. Labour Markets

Luxembourg has been among the hardest hit by the recession in the OECD as trade collapsed and financial activities slowed down



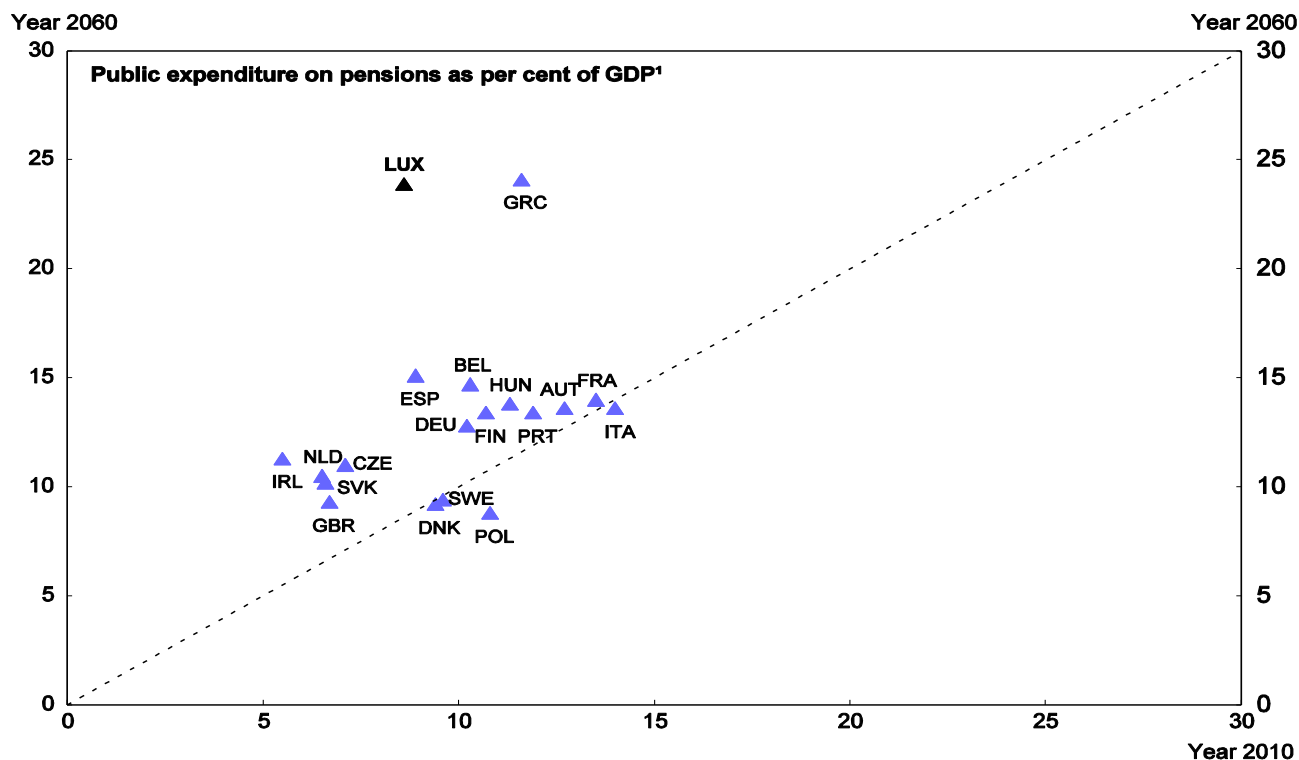
The government responded with a large fiscal stimulus, which helped sustain activity, but is increasing an already rising debt. A return to sound public finances will require a credible consolidation plan.



1. Incorporates information available up to the end of 2009.

Source: OECD, OECD Medium-Term database and Ministère des Finances (2010), 11ème actualisation du programme de stabilité et de croissance du Grand Duché de Luxembourg pour la période 2009-2014.

The consolidation is challenged by large future pension liabilities.

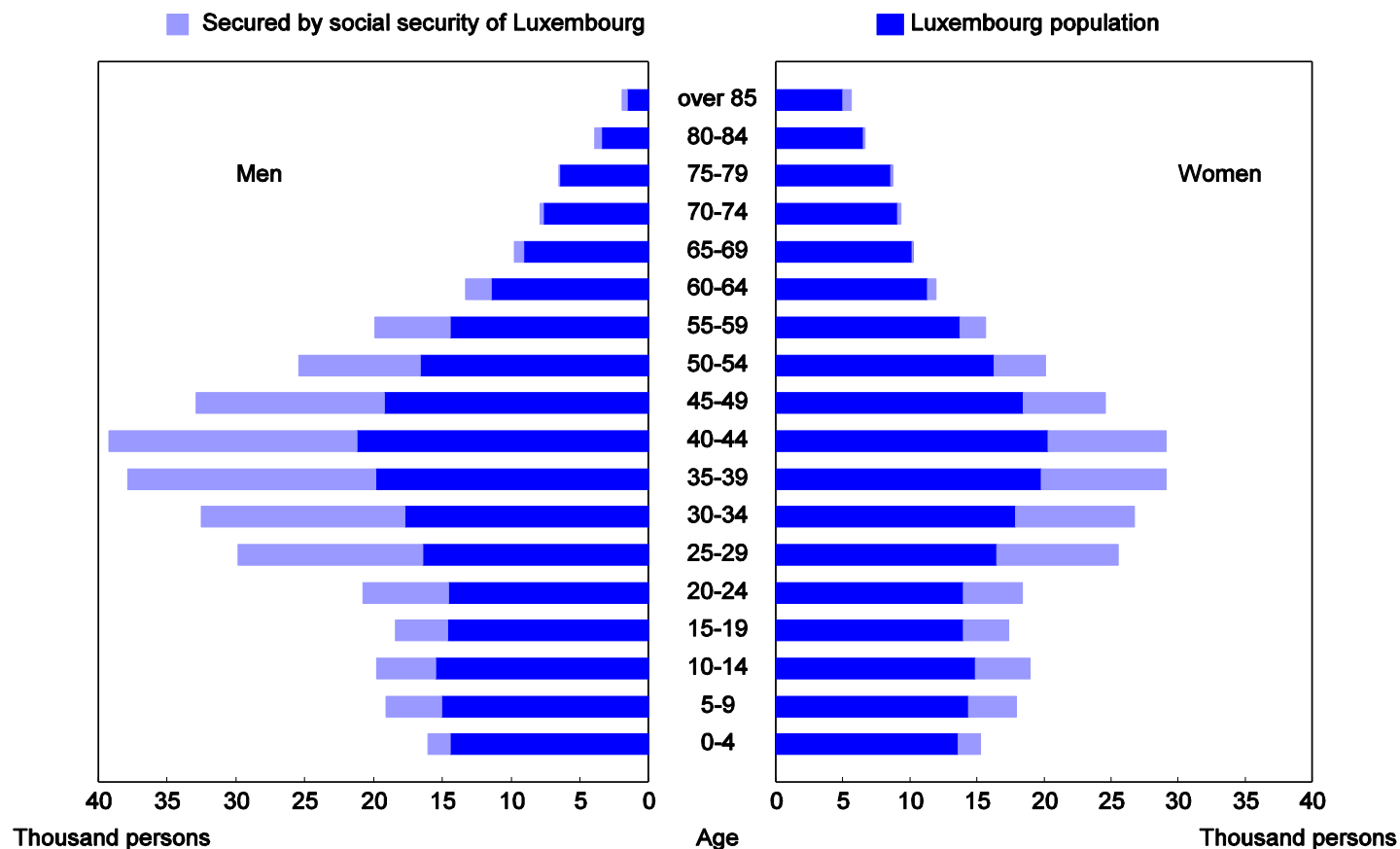


1. EU projections for 2010 and 2060.

Source: European Commission, Sustainability Report 2009.

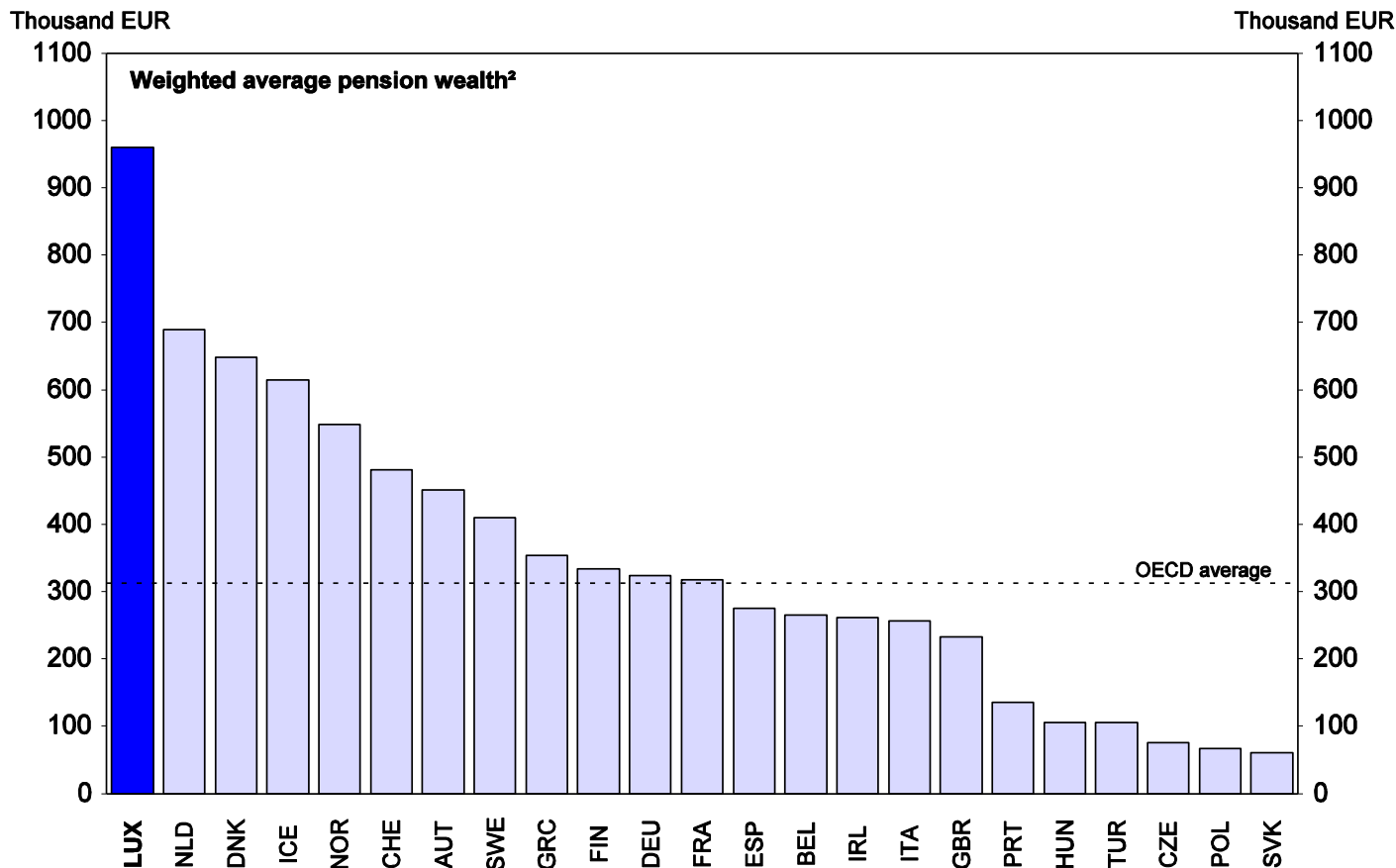
...in the face of a rapidly aging population and ...

Luxembourg population and socially secured persons by gender and by age, 2008



Source: Inspection générale de la sécurité sociale, Luxembourg and EUROSTAT.

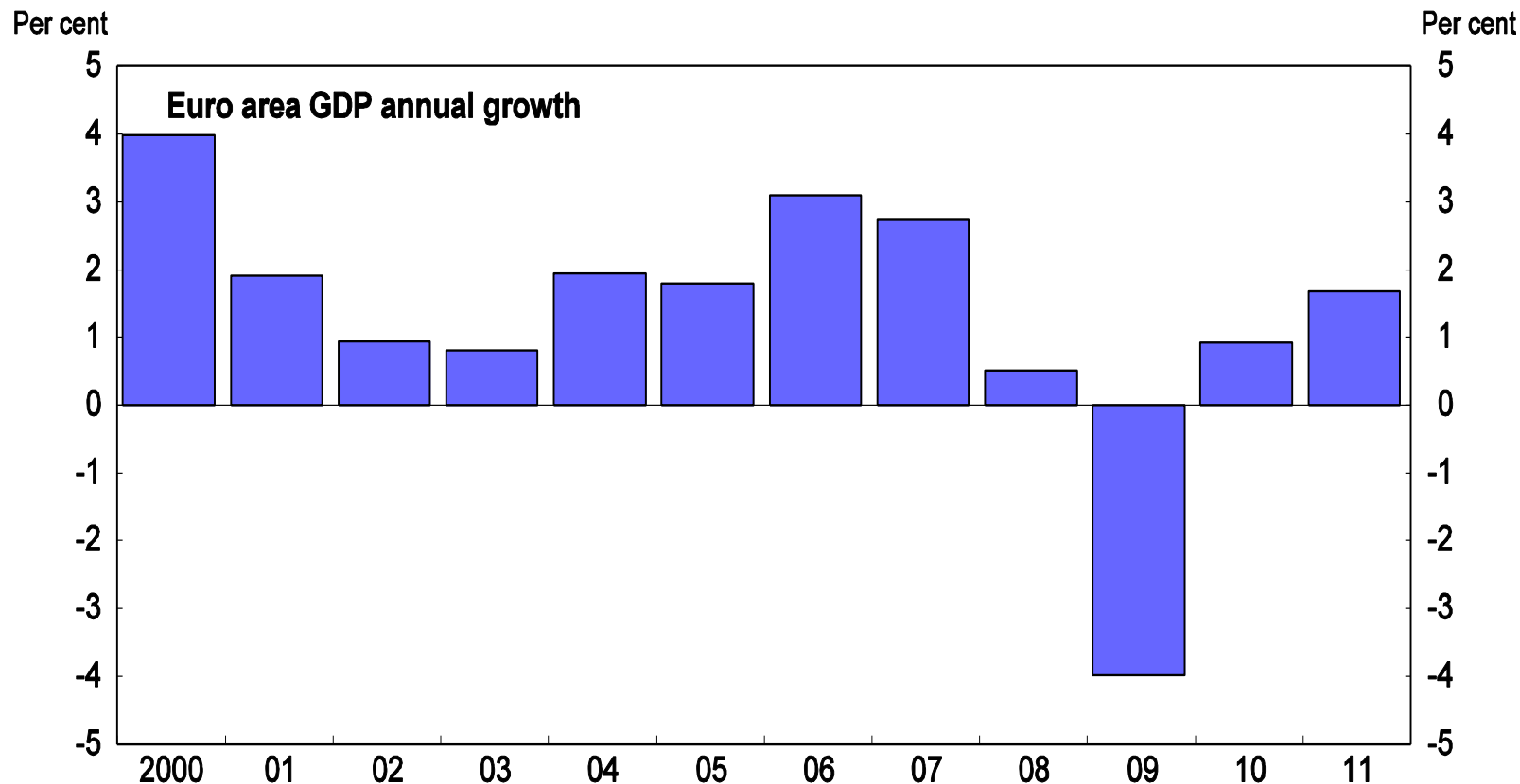
...generous benefits. The net present value of public pension commitments per person in Luxembourg is among the largest in the OECD.



2. Pension model projections based on situation in 2006. Simple average of gender weighted average pension wealth.

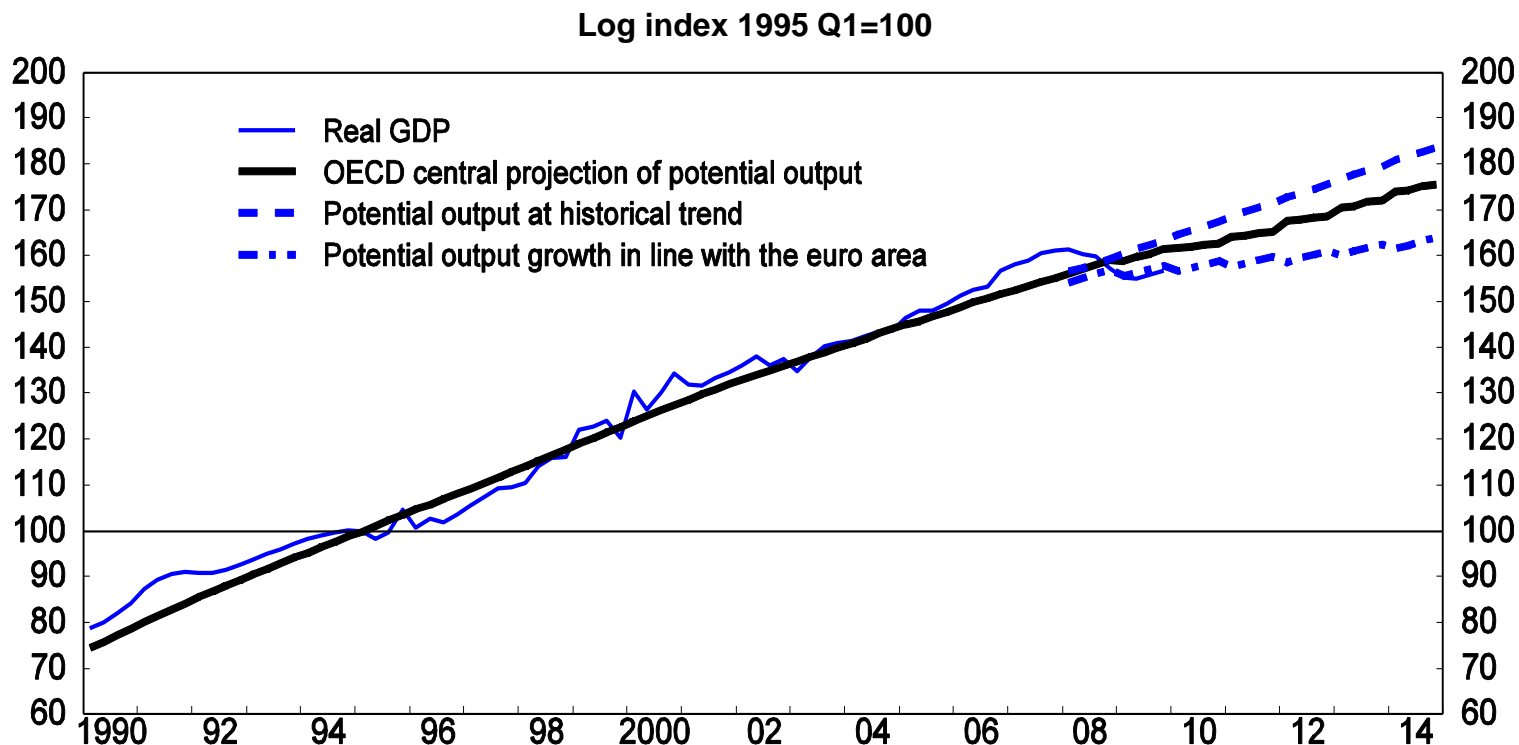
Source: OECD, Pension at a Glance 2009

The recovery will be challenging, as EU growth will be sluggish, and the financial sector faces new regulatory and other challenges!



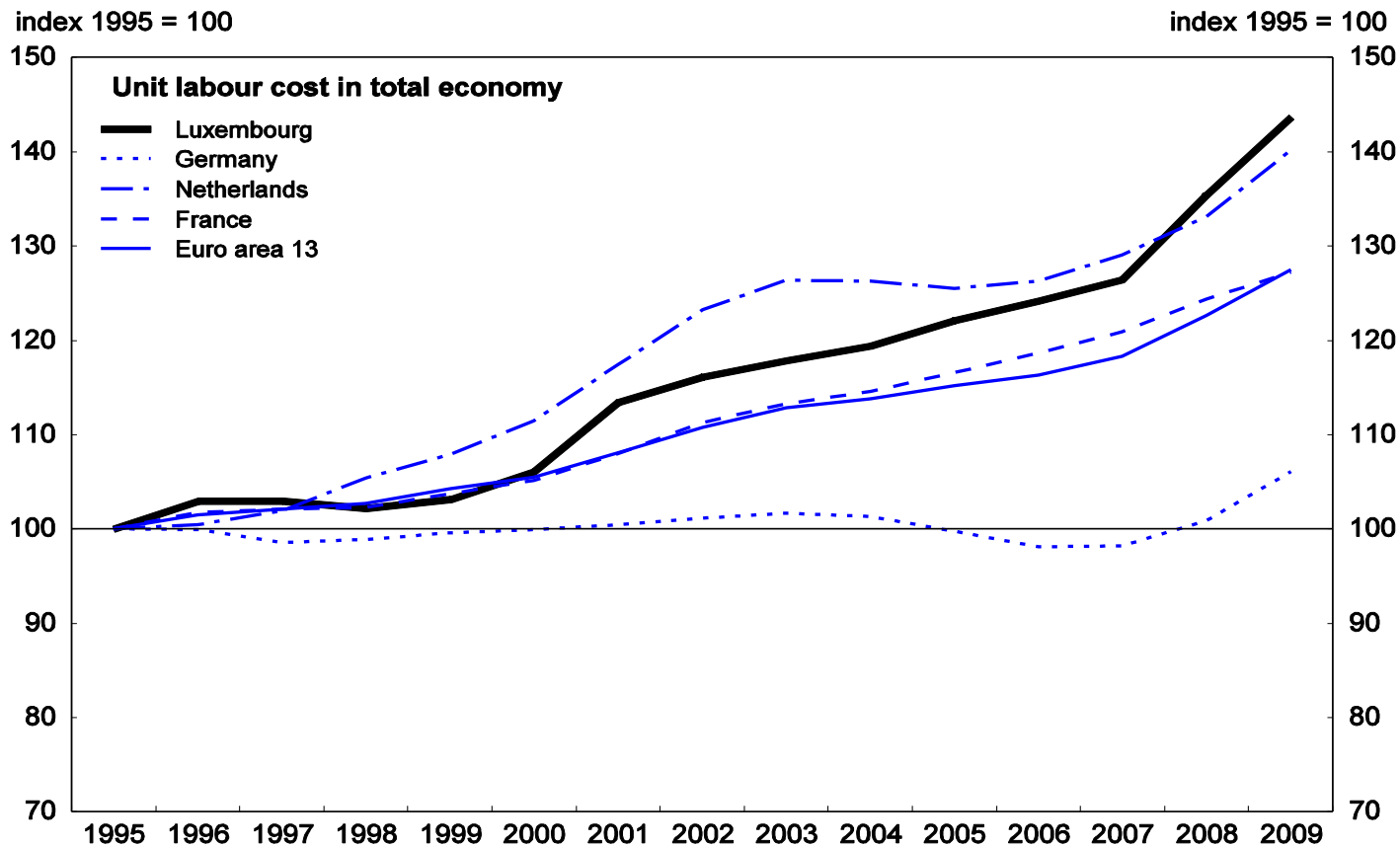
Source: OECD, OECD Economic Outlook database.

Potential growth is likely to be lower as the cost of capital may rise and participation rates decrease



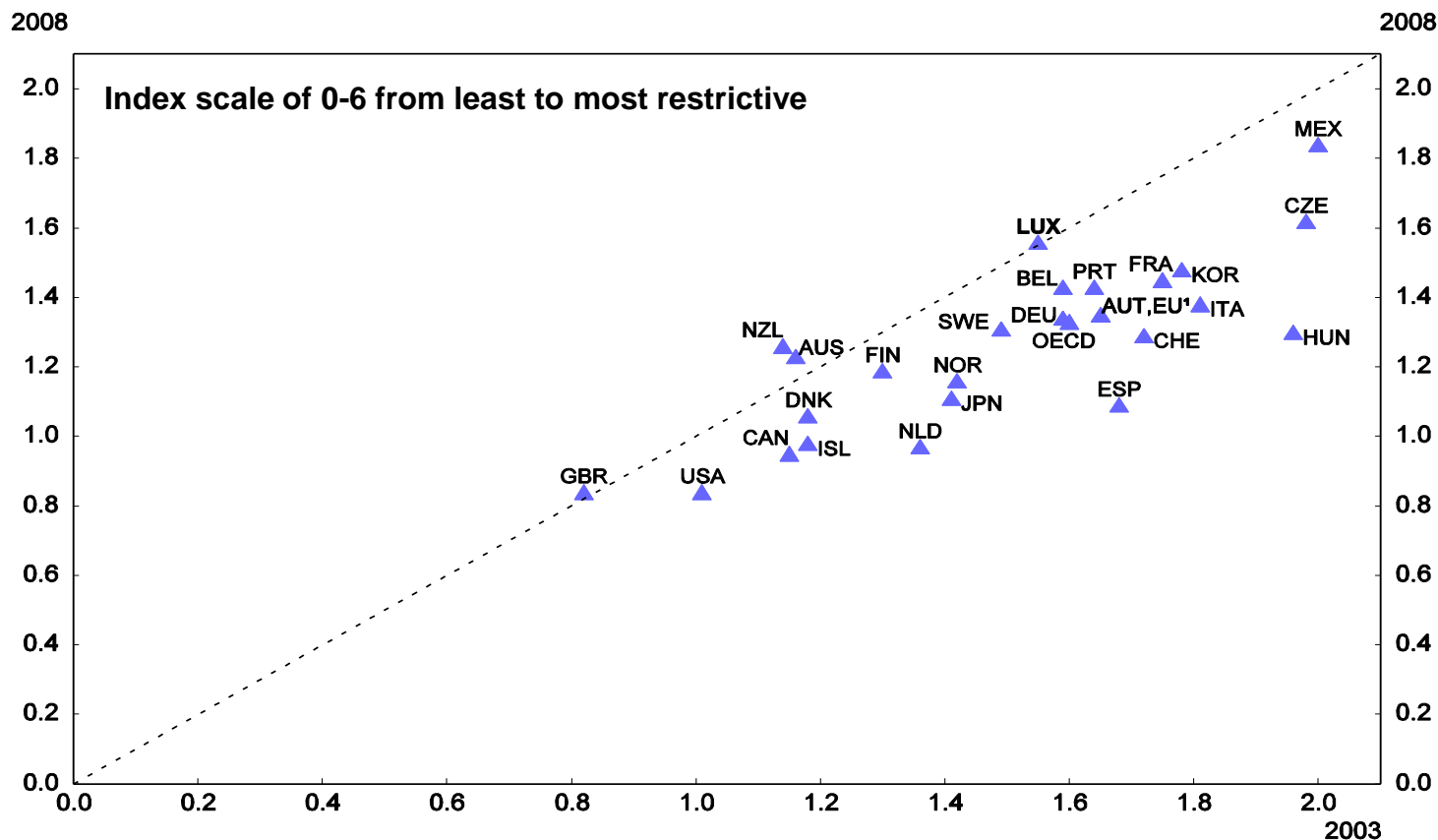
Source: OECD, Medium-Term database and OECD calculations.

..and competitiveness has worsened.



Source: OECD, OECD Economic Outlook database

Recovery may also be constrained by structural rigidities e.g. product market regulation (PMR) are among the most stringent in the OECD



1. EU average correspond to EU19 countries.

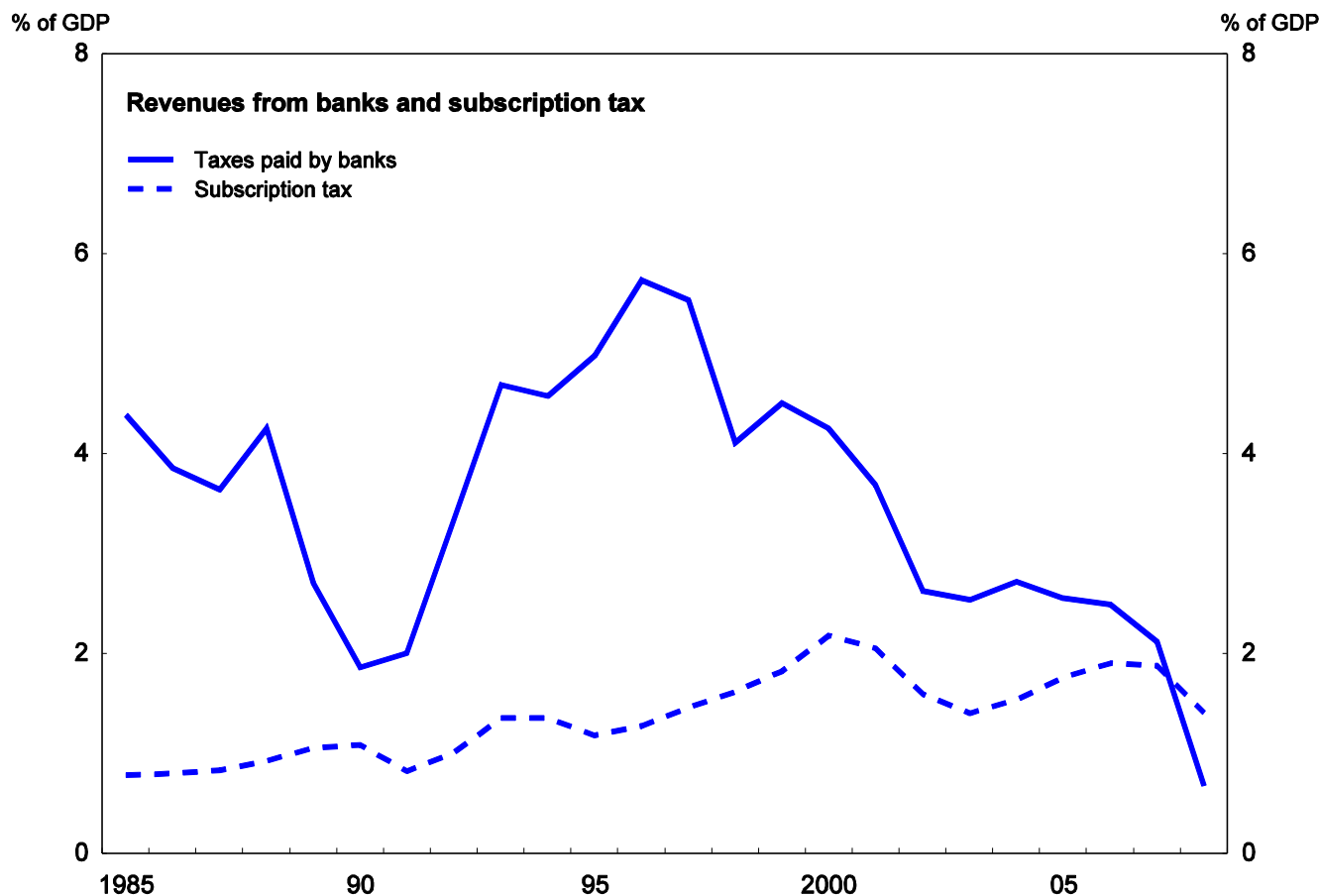
Source: OECD, Product Market Regulation Database.

What can policies do to enhance recovery and growth?

- Announce a credible fiscal consolidation plan and reforms of the pension system (chapter 1)
- Advance structural reforms (chapter 2)
- Address challenges and risks in the financial sector (Artur)
- Improve the functioning of labour markets (Jeremy)

The future of the financial sector is of key importance for growth, employment and public finances in Luxembourg.

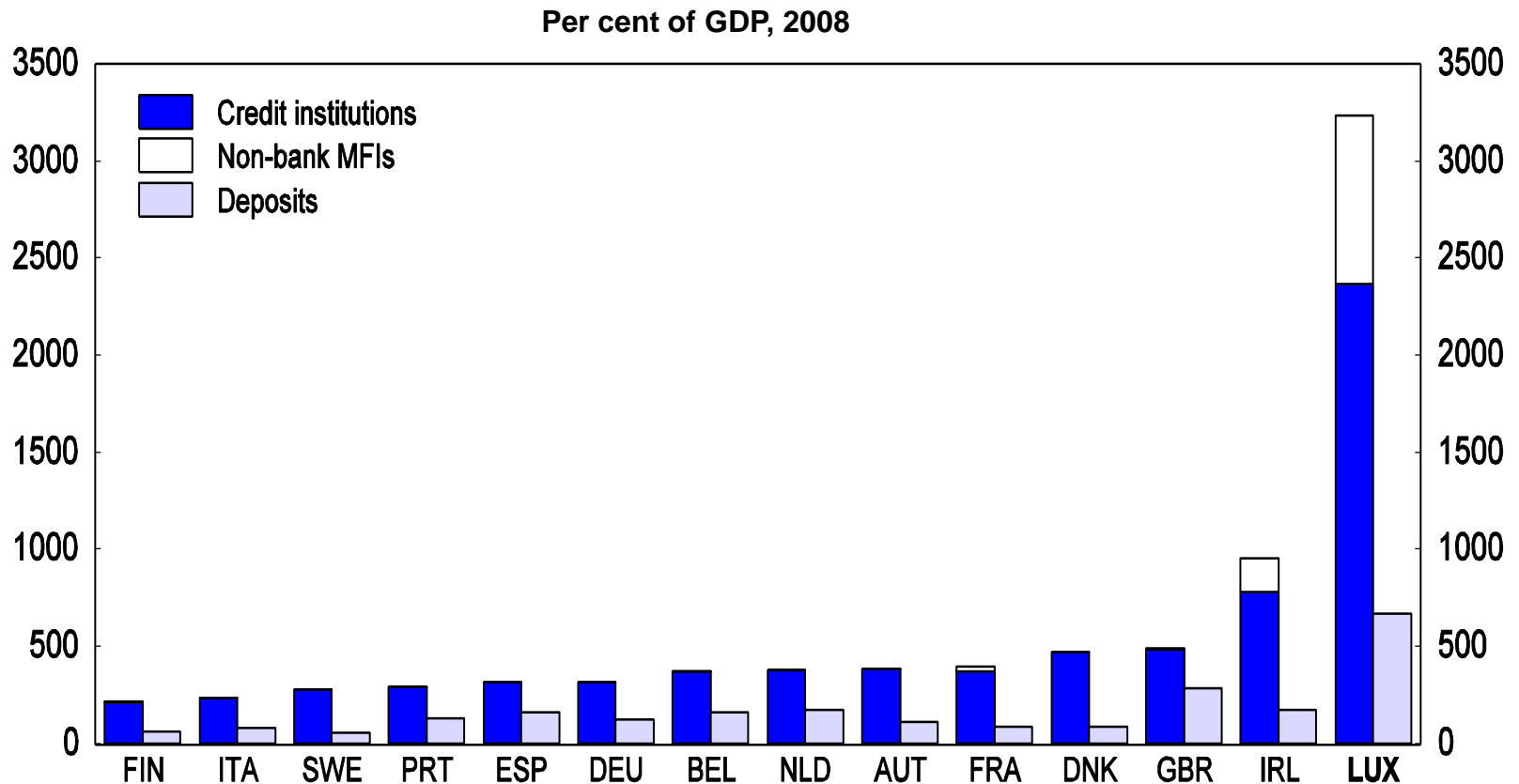
FINANCIAL SECTOR



Source: Statec, Commission de surveillance du secteur financier and OECD, OECD Economic Outlook database.

..its large size also makes the economy vulnerable to financial market trends.

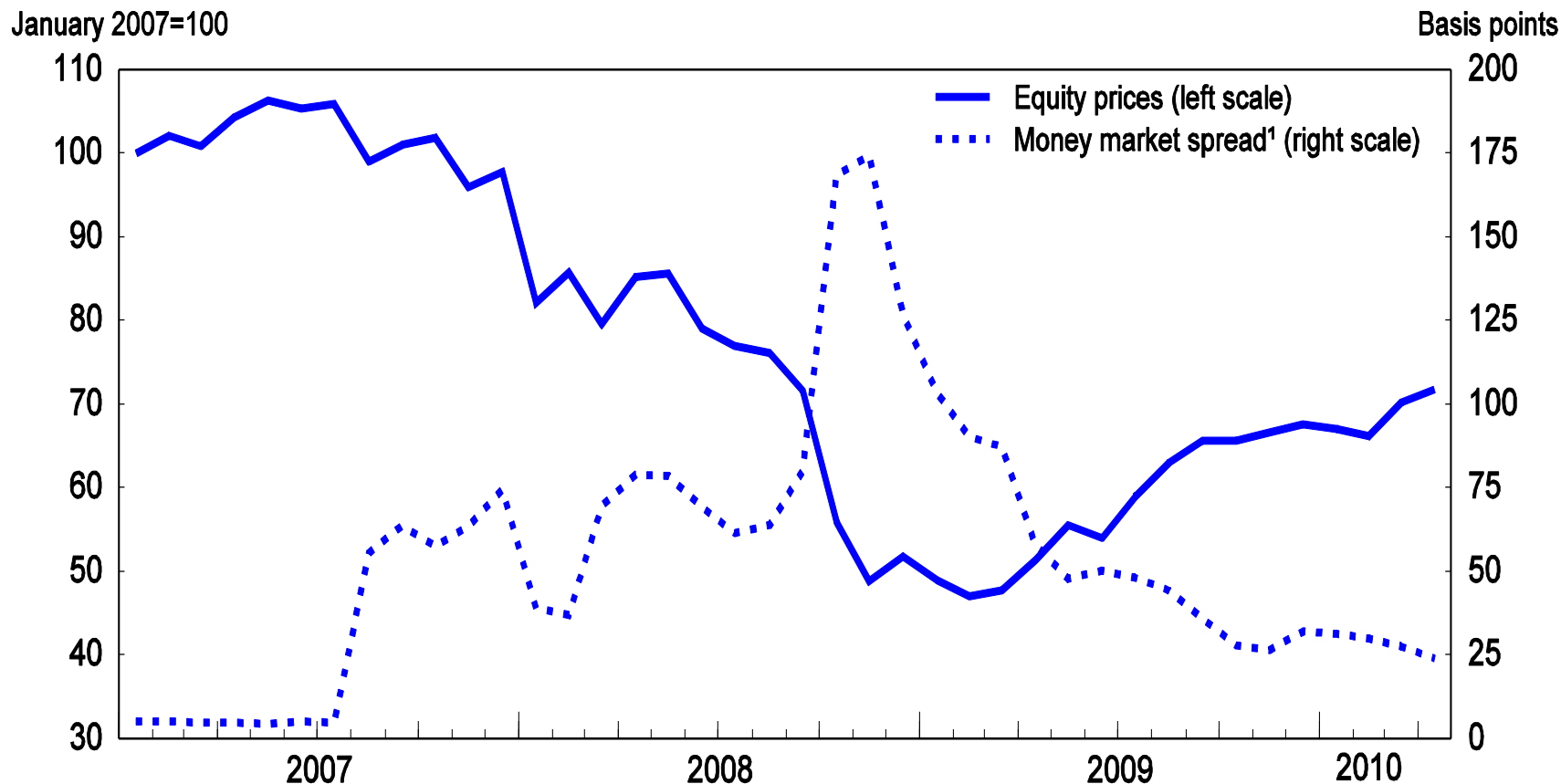
FINANCIAL SECTOR



Source: ECB database and ECB (2010), Structural indicators for the EU banking sector, January.

A recovery has started both in Euro Area and Luxembourg financial markets...

FINANCIAL SECTOR



1. Spread between three-month EURIBOR and EONIA swap index.

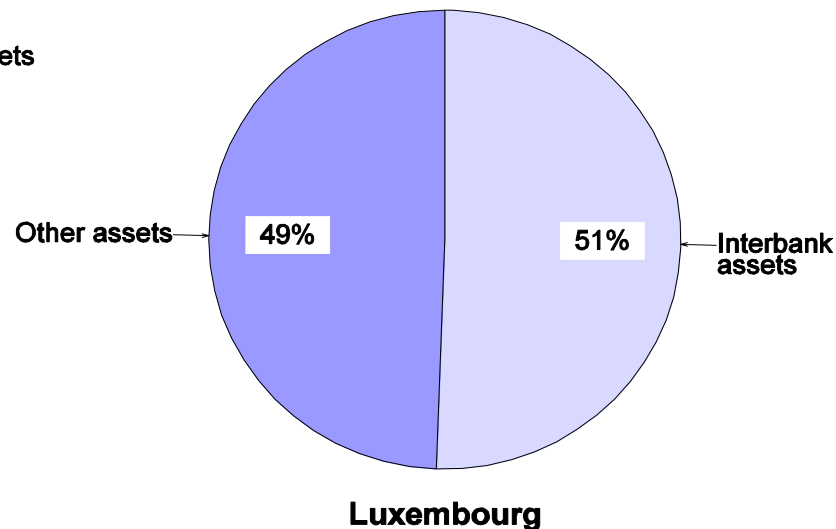
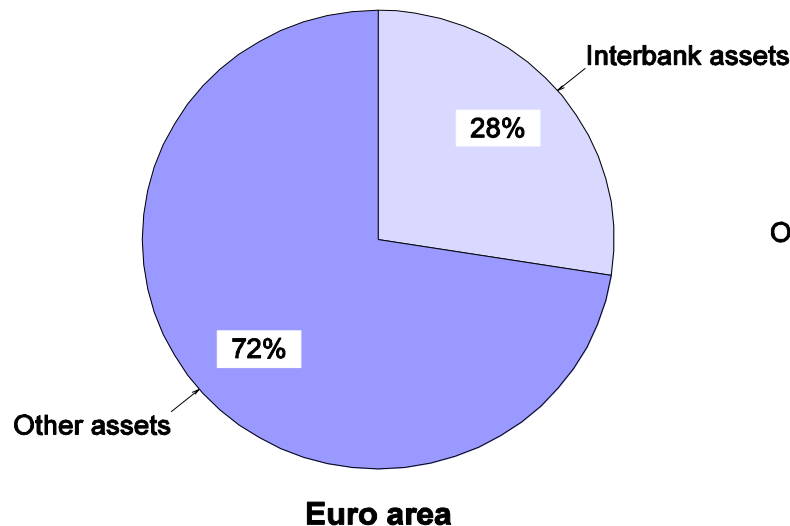
Source: Datastream.

...but faces many challenges and risks.

- The Luxembourg financial sector is narrowly specialised (asset management, intra-bank liquidity, money markets)
- Vulnerable to changes in relevant regulations, in particular
 - new Basel Committee framework on capital and liquidity
 - EU directive on investment funds (UCITS 4)
- Vulnerable to trends in financial industry...
 - sector prospects (e.g.. attractiveness of money market funds vs. inter-bank deposits, private banking)
 - choice of most preferred jurisdictions

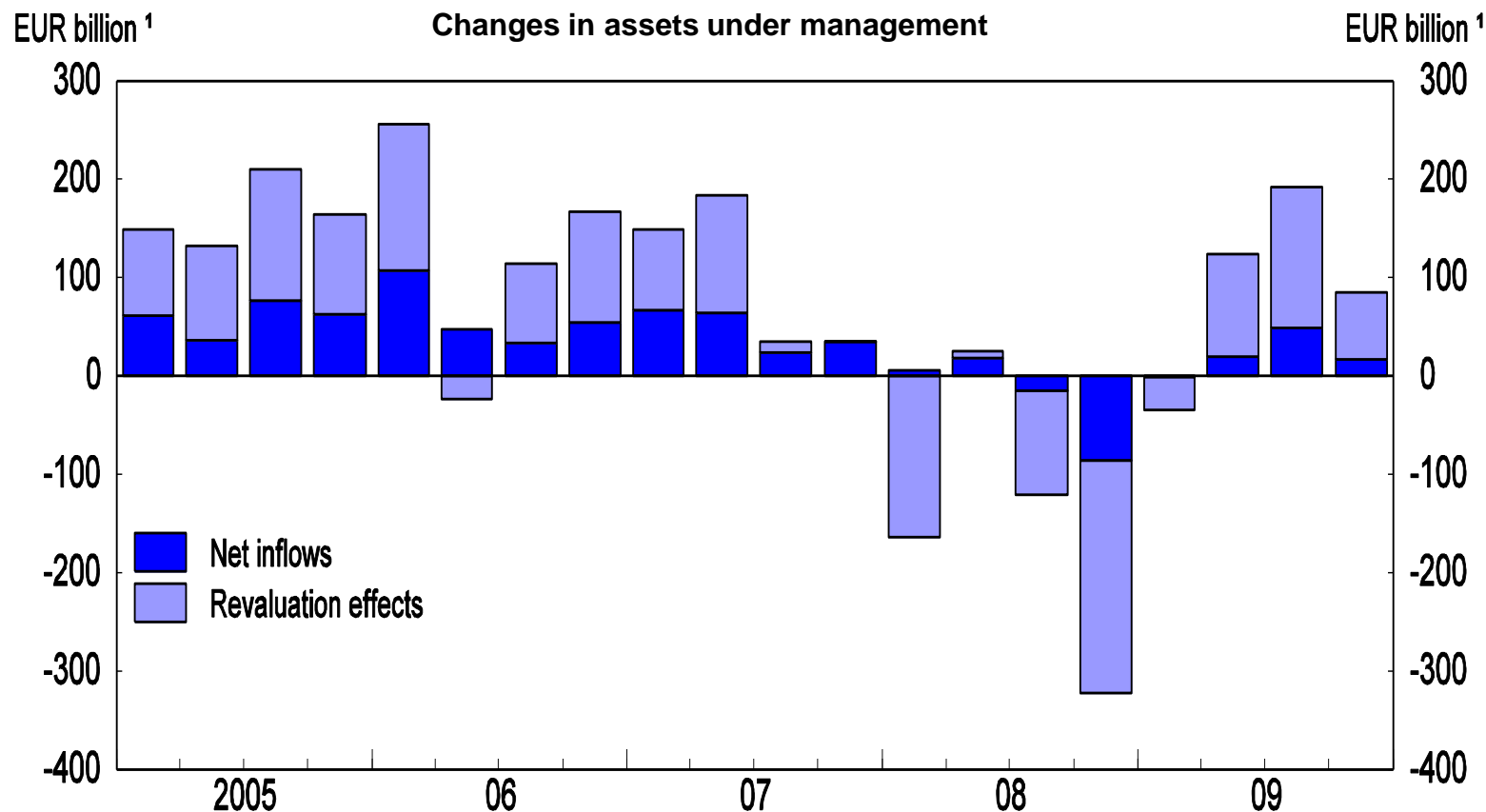
... liquidity management implies inherent risks due to high inter-bank and intra-group exposures...

Average 1999-2009



Source: Central Bank of Luxembourg and Commission de surveillance du secteur financier.

... and asset management is highly pro-cyclical.



1. Quarterly changes based on sum of monthly changes.
Source: Commission de surveillance du secteur financier.

To deal with these challenges, continued effective supervision and improved cross-border co-operation are essential...

- Maintain liquidity regulation in line with emerging new international best practice.
- Participate fully in the development of cross-border supervisory colleges
- Strengthen co-operation between the CSSF and the BCL and consider creating single supervisory institution
- Clarify the requirements on custodian banks and separate ownership between custodial and asset management activities.
- Move to ex-ante funded deposit insurance scheme with risk-based premia and reduce pay-out time to a few days

In addition developing the financial sector would benefit from improved framework conditions:

- Improved transport links and housing supply to increase attractiveness
- Stronger competition and labour market flexibility to improve cost competitiveness (below)
- Enhanced education outcomes to provide necessary skills

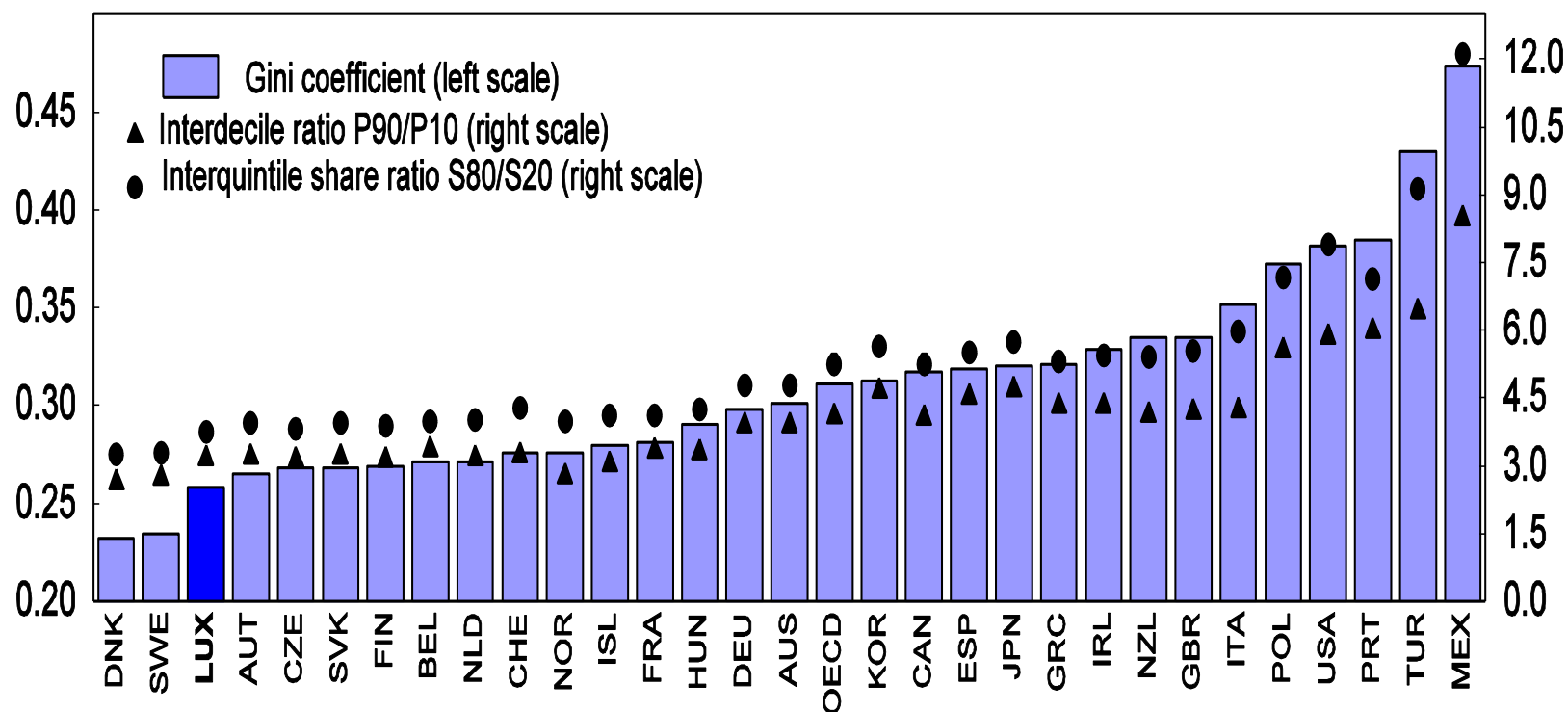
Over the past two decades labour demand has been strong, which has attracted a large number of migrants and cross-border workers

	1991	2008	% change
Population	387 ¹	489 ¹	26
Of which: <i>Foreign-born</i>	113 ¹	216 ¹	91
Employment	195 ¹	349 ¹	78
Of which: <i>Residents</i>	164 ¹	217 ¹	32
<i>Non-residents</i>	31 ¹	131 ¹	320
<i>Public sector</i>	23 ¹	33 ¹	41
Resident unemployment	2 ¹	10 ¹	330
Resident labour force	166 ¹	227 ¹	37
Working-age population	267 ¹	332 ¹	24
Unemployment rate ²	1.4 ²	4.4 ²	
Employment rate ³	61.5 ²	65.5 ²	
Participation rate ³	62.4 ²	68.4 ²	

1. In thousands. 2. In per cent of the resident labour force. 3. In per cent of the resident working-age population.
Source: OECD (2010), *Labour Force Statistics database* and STATEC.

Rapid growth has not been accompanied by a significant increase in inequality

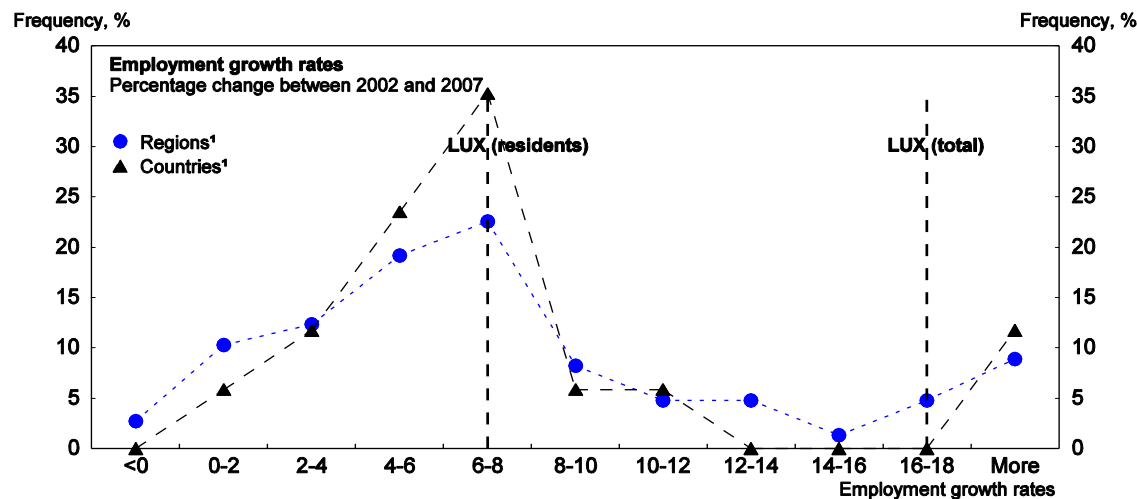
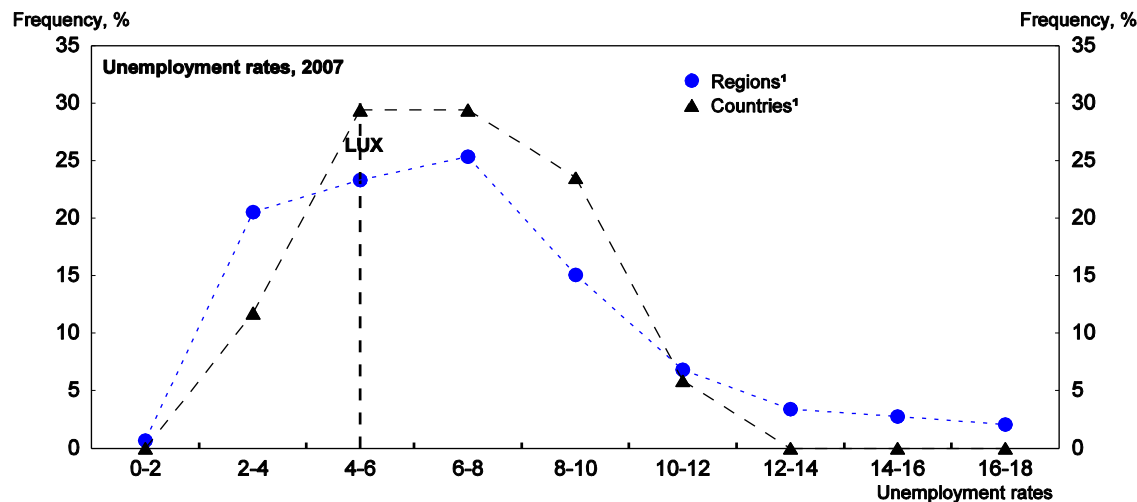
LABOUR MARKET



1. Countries are ranked, from left to right, in increasing order in the Gini coefficient. Data refer to the mid-2000s for all countries except for Japan and Switzerland, where they refer to 2000. The income concept used is that of disposable household income in cash, adjusted for household size with an elasticity of 0.5.

Source: OECD (2008), Growing Unequal? Income distribution and poverty in OECD countries.

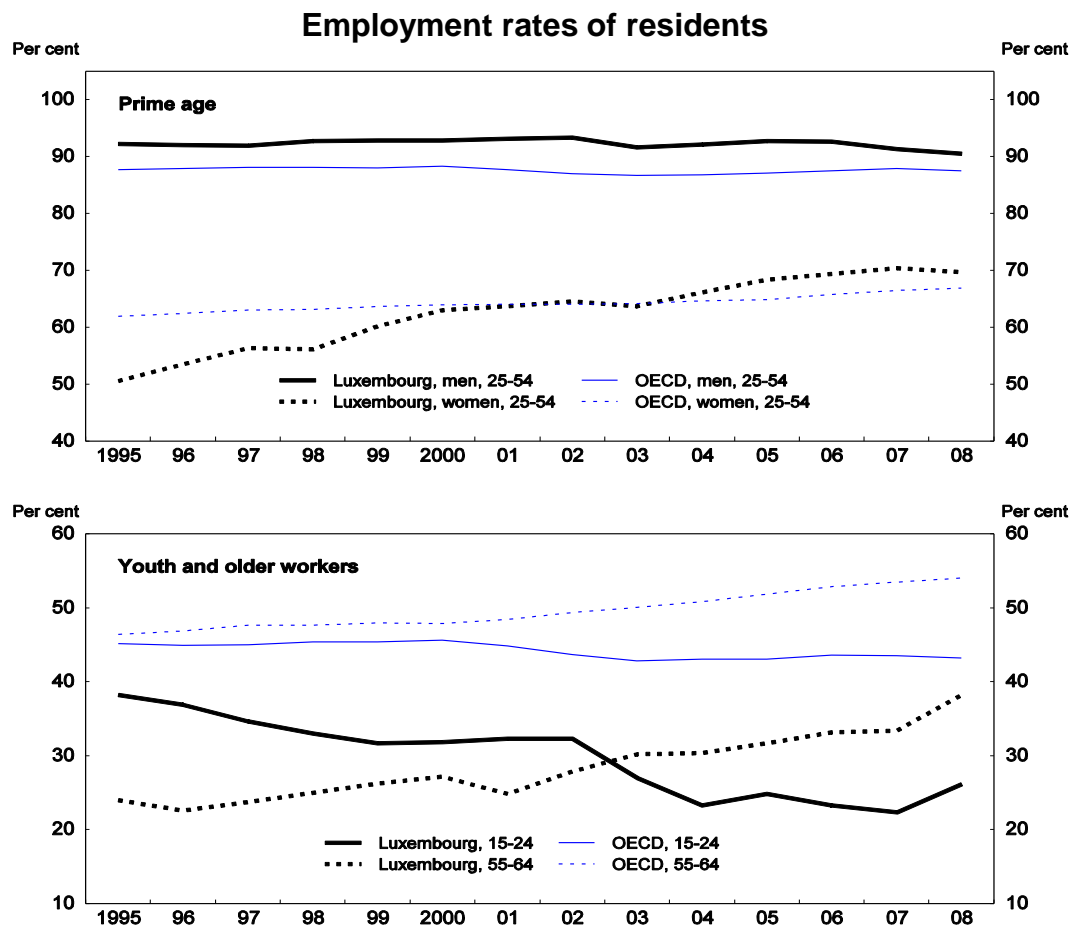
But labour market performance isn't quite so good when compared to other regions



1. European countries and regions cover the euro area 13 as well as the Czech Republic, Norway, Sweden and the United Kingdom.

Source: OECD, Regional Statistics database and OECD Economic Outlook database.

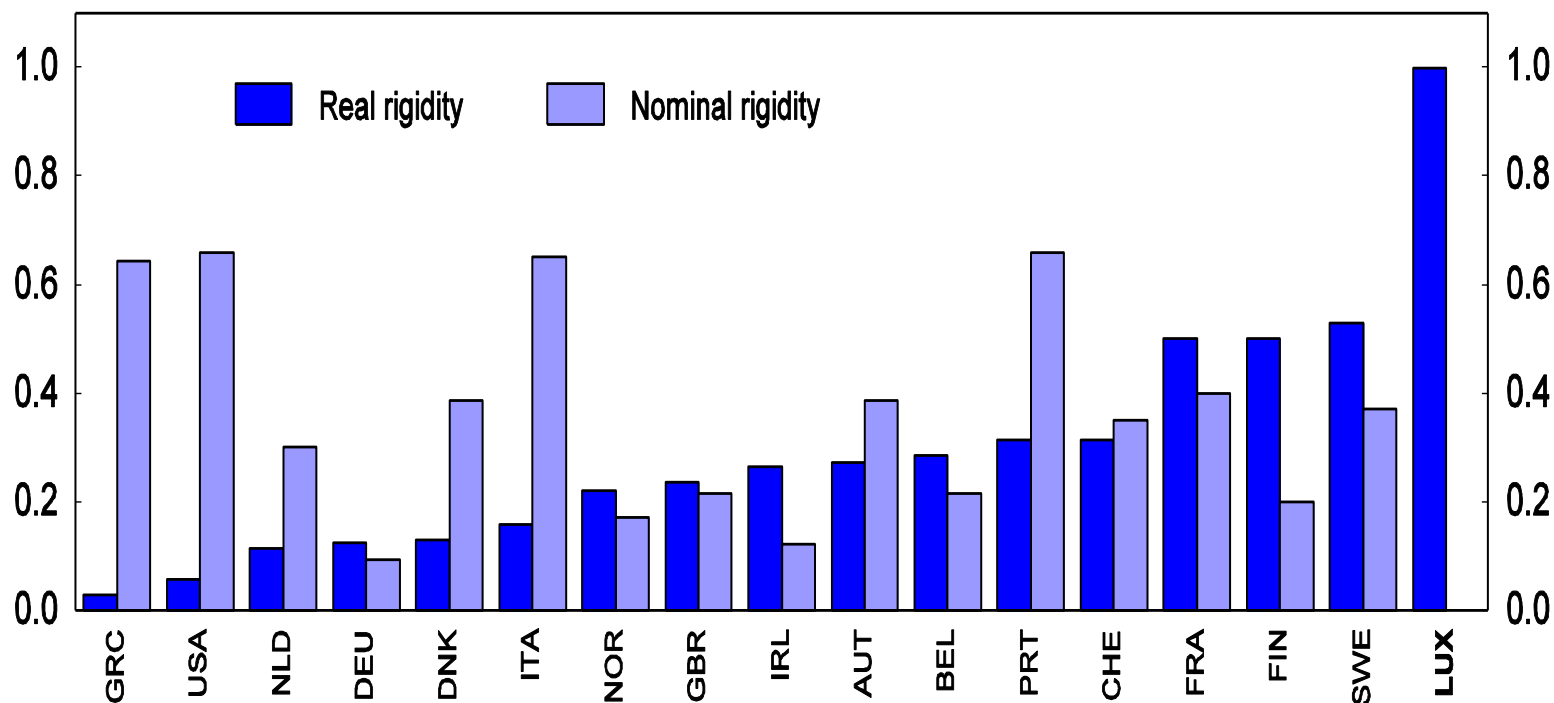
And there are pockets of weak labour market attachment



Source: OECD , Labour Force Statistics database.

Wage indexation reduces the flexibility of real wages

Scale index from 0 (where no one is subject to the rigidity)
to 1 (where all workers are potentially affected)

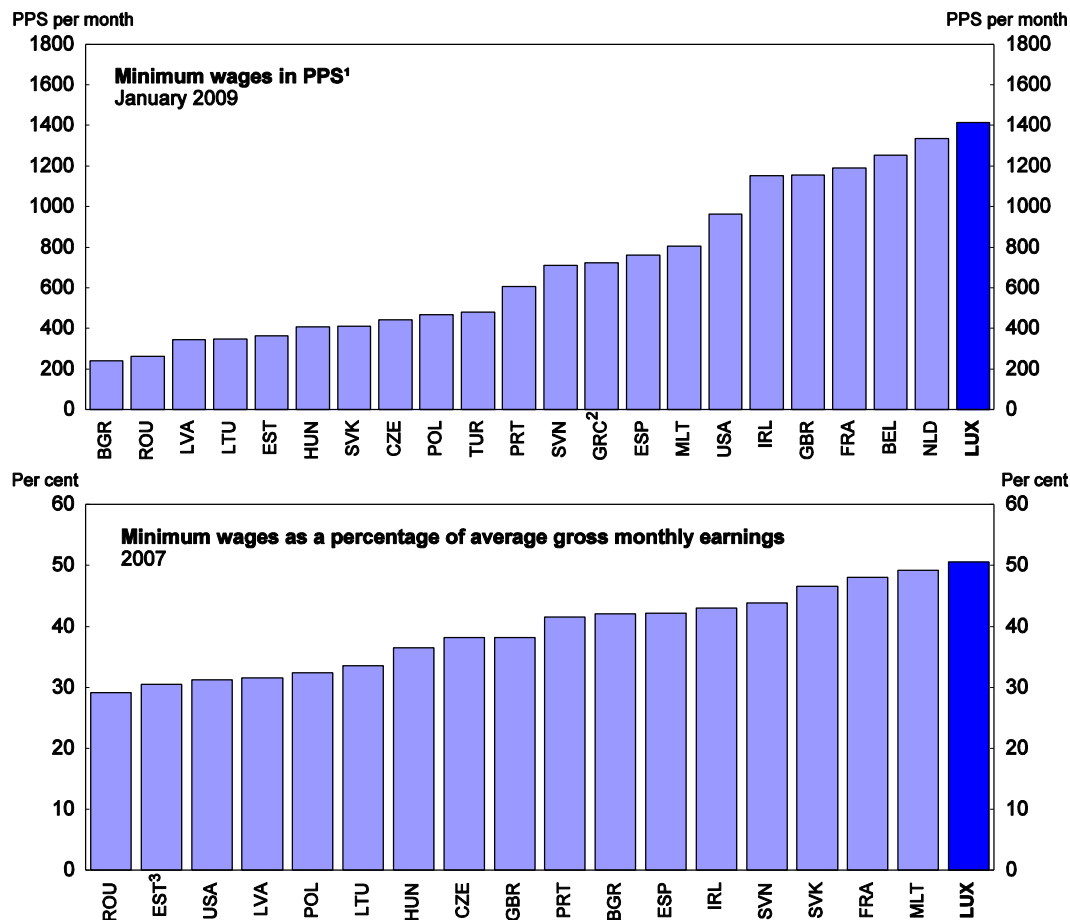


1. Mixed Method of Moments estimates of the prevalence of downward real wage rigidity and the prevalence of downward nominal wage rigidity, averaged across all dataset-years for each country. By construction, the measures range from 0 (where no one is subject to the rigidity) to 1 (where all workers are potentially affected).

Source: Dickens, W. et al. (2007), 'The Interaction of Labour Markets and Inflation: Analysis of Micro Data from the International Wage Flexibility Project' and Lünemann and Wintr (2010) for Luxembourg results.

While the setting of minimum wages needs to focus more on economic criteria

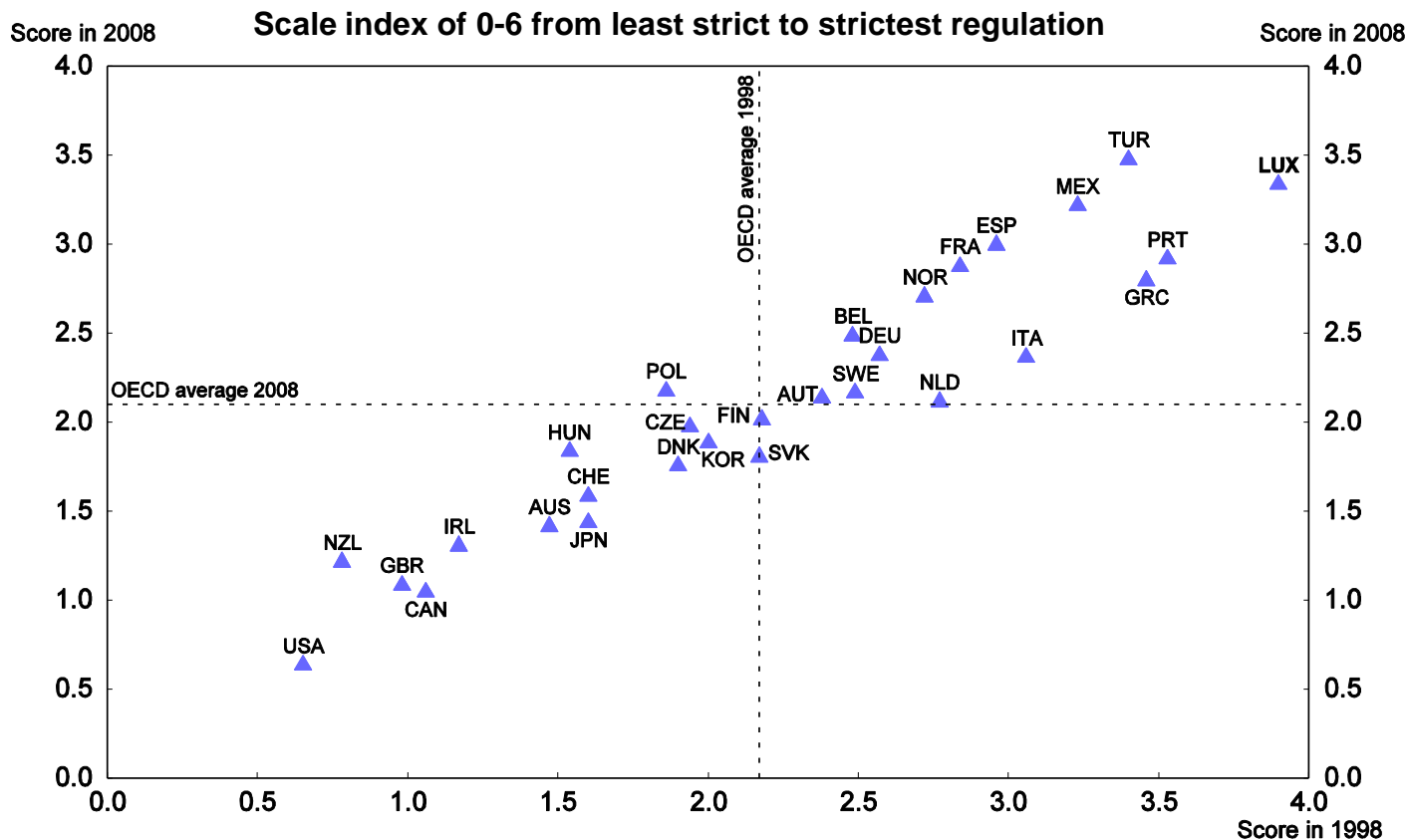
LABOUR MARKET



1. Estimated values based on 2008 PPS data.; 2. July 2008.; 3. 2006.

Source: Eurostat.

And employment protection legislation is far too strict



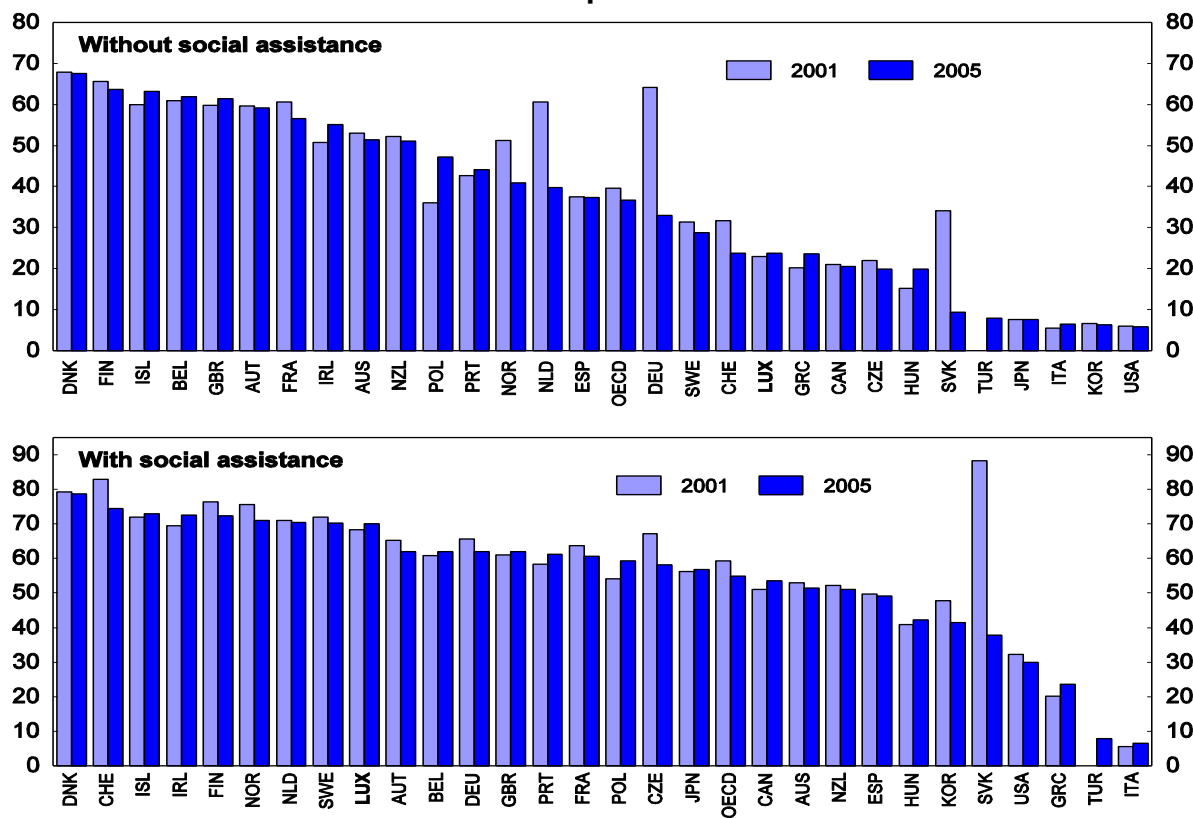
1. Luxembourg data are from 2003 and 2008

2. The OECD indicators of employment protection are synthetic indicators of the strictness of regulation on dismissals and the use of temporary contracts.

Source: OECD, Labour, Employment protection database.

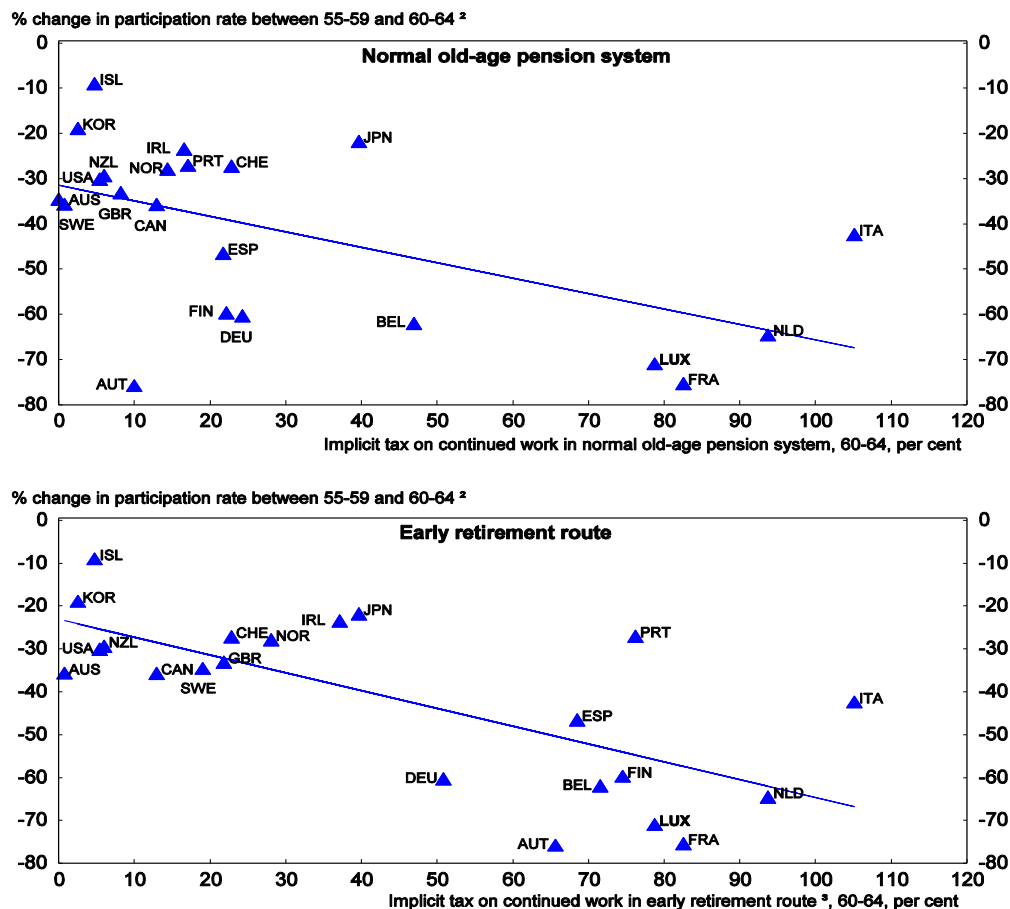
Reforms to boost labour demand must be complemented by reforms that increase work incentives for marginalised groups

Average of net replacement rates over a period of 60 months
In per cent



Pension reform is especially critical given the low participation rates of older workers

Single worker APW earnings, 1999



Source: Duval, R. (2003), The Retirement Effects of Old-Age Pension and Early Retirement Schemes in OECD Countries, OECD Economics Department Working Papers, No. 370, OECD, Paris; and OECD (2010), Labour Force Statistics database.

What can policies do?

- Increase work incentives by:
 - Phasing down unemployment benefit replacement rates;
 - Tightening young people's eligibility for unemployment insurance;
 - Improving the public employment service and strengthening activation policies;
 - Ensuring all labour market programmes are cost effective;
 - Reducing the generosity of social benefits;
 - Considering the introduction of a system of in-work benefits; and
 - Reforming the pension system to reduce early retirement incentives.

- Reform the system of wage setting:
 - At first, index wages to core rather than headline prices and eventually end automatic wage indexation.
- Enhance the effectiveness of the minimum wage:
 - Focus on the economic impact of adjustments and set up an independent Minimum Wage Council.
- Reduce the strictness of employment protection legislation.