OECD Economic Survey of Luxembourg, May 2010

OVERVIEW

Summary

Luxembourg has experienced a severe recession, as it was heavily exposed to the fall in world trade and the international financial crisis. Unemployment has risen and the fiscal position has deteriorated. This follows a long period of continuous and rapid economic expansion during which living standards rose impressively and the economy was transformed by the growing financial centre and large flows of cross–border and migrant workers. While there are encouraging signs of recovery, the future growth path is likely to be weaker than in the recent past reflecting the sluggish international recovery, structural factors and a loss of competitiveness.

Exiting from the crisis. The substantial fiscal stimulus needs to be unwound. The structural deficit in the public finances will need to be addressed given the vulnerability of the Luxembourg economy to external shocks and the longer–term fiscal challenge from ageing. Consolidation plans need to be implemented with an emphasis on containing current expenditure and within a more robust budgetary and institutional framework. The unemployment rate is at a historically high level and could be reduced through appropriate structural measures to boost labour demand and get the unemployed back to work. Economic recovery could be encouraged by improved competitiveness.

Securing long–run fiscal sustainability. The main challenge comes from high pension costs due to ageing, generous benefits and the increasing number of cross–border workers who will reach retirement age. Pension reform, together with fiscal consolidation, is required to put the public finances on a sustainable footing. Fiscal consolidation is an opportunity to increase public sector efficiency as well as to strengthen budgetary institutions.

Avoiding long–term unemployment. Residents' unemployment rose even during the growth years and the crisis has further increased unemployment. Some groups, including younger and older workers, have relatively low employment rates. The functioning and adaptability of the labour market would be improved by making its regulation less rigid and by ensuring that generous social benefits do not reduce the incentive to work.

Maintaining a well–regulated financial centre. Banking and asset management activities in the financial centre play an important role in the overall economy. They were adversely affected by the international financial crisis, although knock–on effects to the real economy have been rather muted. The risks inherent in these activities, related to substantial cross–border exposures, appear to have been well managed. However, the crisis leaves the financial industry's future prospects more uncertain. Effective supervision and improved cross–border co–operation will help to manage risk in the financial system, while solid domestic framework conditions will contribute to the development of the financial centre.

Achieving growth with flexibility and efficiency. Though living standards should remain high, it is to be assumed that potential growth is likely to be lower in the coming years. This underlines the need for structural reforms. Competition should be enhanced, notably in the services sectors. Further education reforms are needed to raise skills and knowledge standards. Housing and transport policies should do more to support sustainable economic development and continue to make Luxembourg an attractive location for business. Reducing high *per capita* CO_2 emissions will be a major challenge.

Assessment and recommendations

The economy is coming out of a severe recession

Luxembourg has experienced a severe recession, as its international links exposed it to the financial crisis and the steep fall in world trade. The very open financial and industrial sectors contracted sharply. The financial impact of the crisis has been primarily on internationally–oriented banking and fund management activities. However, there is little evidence of serious credit constraints facing the domestic economy. Luxembourg participated in the cross–border rescue of two financial institutions with extensive local activities, though their local subsidiaries were not at the origin of the problems. Employment growth has stalled, leading to a rise in unemployment among the resident labour force. A large–scale short–time working scheme in manufacturing has contributed to cushion against further job losses. The fiscal stance has eased markedly due to automatic stabilisers, large stimulus measures and lower revenues from financial activities. The accommodative stance of euro area monetary policy has provided further support. Headline inflation has been volatile in recent years due to increases in food and energy prices, and underlying price pressures have been somewhat stronger than the euro area average. Competitiveness has deteriorated in recent years as wage increases have outpaced productivity gains.

Table 1. **Key macroeconomic developments**

	Current prices EUR billion	Percentage changes, volume (2006 prices)	
	2007	2008	2009
GDP at market prices	29.5	0.0	-3.4
Private consumption	10.3	3.9	-0.6
Government consumption	4.4	3.0	2.9
Gross fixed capital formation	6.9	-0.1	-14.9
Final domestic demand	21.6	2.5	-3.9
Stockbuilding[1]		0.5	-0.5
Total domestic demand	21.7	3.2	-4.7
Exports of goods and services	53.8	1.5	-7.6
Imports of goods and services	46.1	3.3	-9.2
Net exports[1]		-2.1	-0.2
Memorandum items			
Consumer prices		3.4	0.4
Underlying consumer prices		2.0	1.7
Private consumption deflator		3.7	0.0
GDP deflator		5.0	-0.7
Employment (national accounts basis)		4.7	0.9
Unemployment rate		4.4	5.7
General government financial balance[2]		2.5	-0.7
Current account balance[2]		5.3	5.6

1. Contributions to changes in real GDP (percentage of real GDP in previous year).
2. As a percentage of GDP.

Source: OECD, *OECD Economic Outlook database* and provisional update to the *Economic Outlook 86* projections.

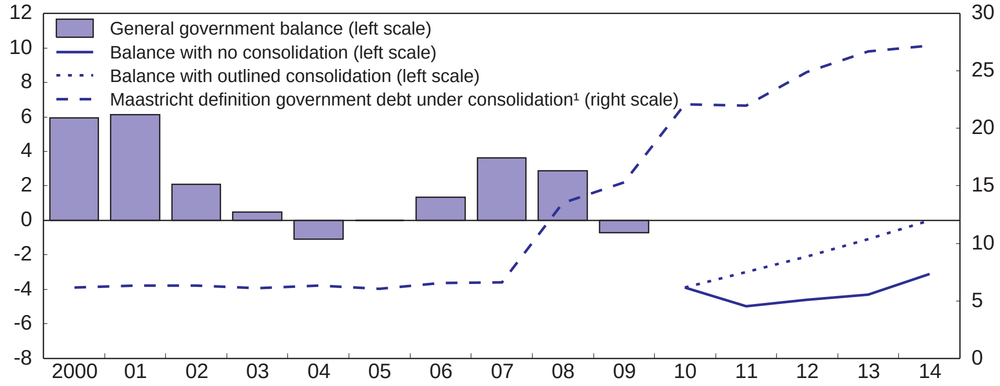
The tentative recovery began with a sharp pick–up in activity in the third quarter of 2009, driven by net exports and growth in consumer spending. In the coming years, growth is anticipated to be stronger than the euro area average, but lower than in the pre–crisis years. Indeed, demand will be held back by weak competitiveness, the necessary fiscal consolidation and sluggish growth of potential output. In light of Luxembourg's high exposure to financial and trade developments, this recovery scenario is surrounded by substantial risks. Although living standards should remain high, potential output is likely to be lower in the coming years than previously anticipated. This is the result of reduced financial sector activity and slower euro area growth. There is also great uncertainty about the long–term growth rate, given the highly specialised economy and uncertain prospects for the financial sector in the wake of the crisis, but it is likely to be lower than the trend of past decades. A reduction in the average growth rate over a sustained period will have major implications for the economy and the sustainability of public finances.

Fiscal consolidation is required to restore the public finances

The fiscal position has deteriorated substantially after many years of good performance. The surplus of more than 3% of GDP is likely to turn to a deficit of similar magnitude by 2010, driven by the automatic stabilisers, one of the largest stimulus packages relative to GDP in the OECD, as well as large falls in revenues from banks. The sound starting position and low debt burden allowed for the large and timely fiscal stimulus package. Nevertheless, its impact on demand is likely to have been modest given the openness of the economy. Some of the revenue shortfall will be permanent: banking sector profitability is expected to be lower than in the recent past because the credit cycle has turned and the volume of assets under management is unlikely to recover fully in the coming years. Meanwhile, spending has continued to rise strongly due to the stimulus measures and higher social expenditures. To reflect the potential effect of implicit liabilities on the long–term sustainability of public finances, the authorities have revised their Medium–Term Objective under the Stability and Growth Pact from a small deficit to target a small surplus. This is appropriate given future ageing–related spending and high dependence on volatile financial sector revenues. However, the consolidation plans set out by the government do not envisage reaching this target for at least five years. *These plans should be implemented and consideration given to adopting a more ambitious consolidation path*. Consolidation will be more effective if it focuses on containing current expenditures, rather than on revenue measures, and if accompanied by more robust fiscal institutions. Given the unusually uncertain long–term prospects, the public finances should continue to be managed on a prudent basis. Budgetary institutions and procedures should be strengthened to facilitate the consolidation process with greater emphasis on multi–year plans.

Figure 1. **Government budget projections**

As a percentage of GDP



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".

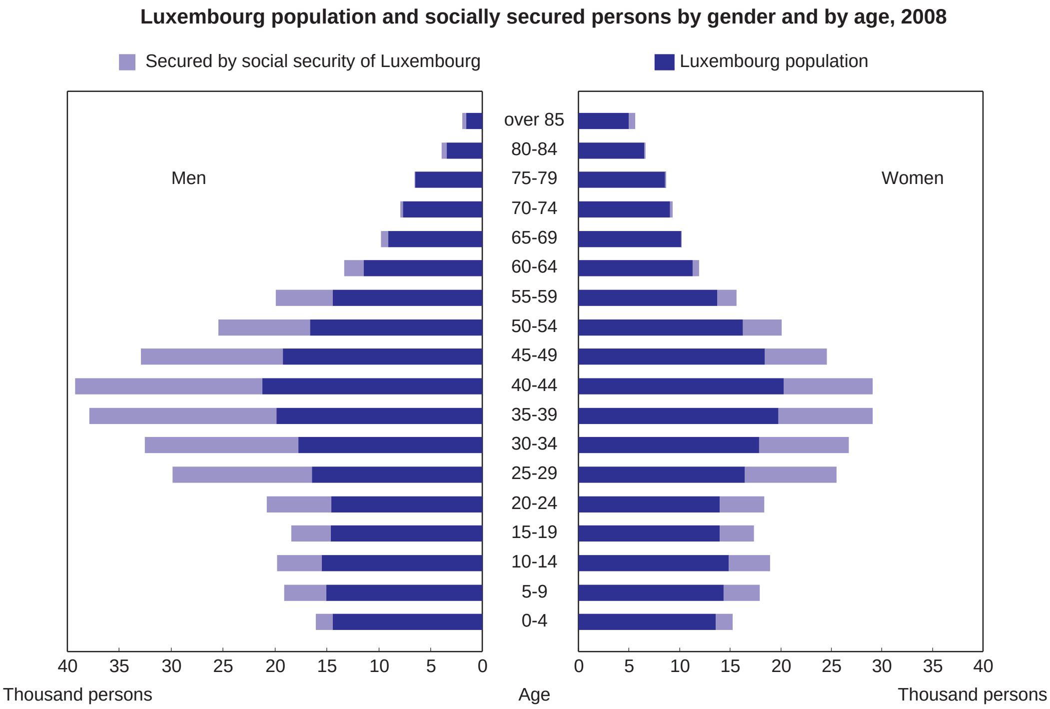
Fiscal consolidation provides an opportunity to enhance public sector efficiency and responsiveness to citizens. While spending on public services is high, the organisation of the public sector should be adapted to modern practices. In a career–based system with limited ability to bring in outside skills, as well as promotions based on seniority and limited mobility between departments, human resource management remains extremely inflexible,

- *There should be a shift from an input–based to an output–based system for the allocation of public spending. A system of performance budgeting should be introduced* to improve resource allocation, with greater localised discretion and effective central monitoring of performance.
- *Capital projects should systematically be subject to cost–benefit analysis* to ensure cost efficiency.
- *Human resource management should be upgraded with the introduction of performance–based advancement/pay and greater openness in recruitment.*
- To ensure access to the widest possible pool of talent, *the law on access of EU nationals to public–service employment should be implemented in a way to make recruitment as open as possible.*
- Health spending cost controls are relatively weak by international comparison. *The health system should be made more efficient by strengthening the control of costs, empowering hospital managers, improving the flow of information and using health facilities in the neighbouring countries.*

Pension reform is needed to achieve long–run fiscal sustainability

While there are few immediate pressures on fiscal sustainability, the long–run budget position is however much weaker due to large future pension liabilities. If potential growth were to slow substantially in the aftermath of the crisis, this would increase fiscal pressures. The short–term financing of the pension system is currently supported by a low old–age dependency ratio, as well as by contributions paid by relatively young cross–border workers. In the future, both factors will reverse and pension costs are anticipated to increase substantially.

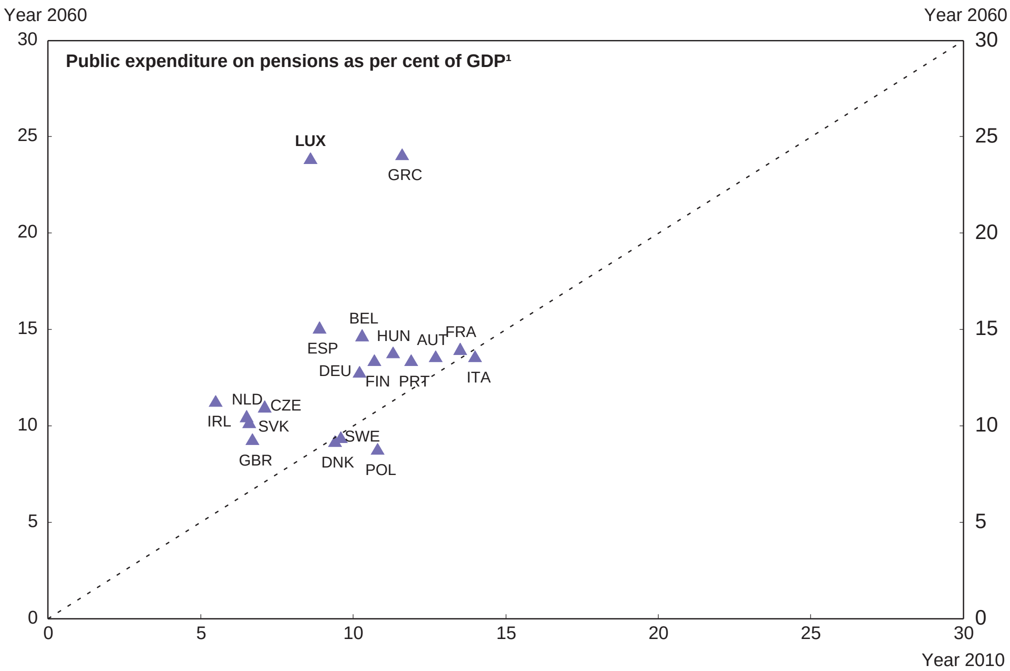
Figure 2. **The demographic structure of the workforce**



Source: Inspection générale de la sécurité sociale, Luxembourg.

Although the government has sizeable and growing pension reserves, they will not suffice to sustain the system in the medium and long term. Pension benefits are very high by OECD norms and the system cannot be sustained without substantive reform. Luxembourg is one of very few OECD countries not to have undertaken major reforms. *The pension system needs to be reformed now*. Reforms could include raising the effective retirement age, reducing the pension replacement rate over time, limiting credits for years spent outside work, introducing actuarial fairness around retirement age and indexing the retirement age to longevity. To raise the effective retirement age, *early retirement schemes should be abolished*.

Figure 3. **The costs of future ageing**



1. EU projections for 2010 and 2060.

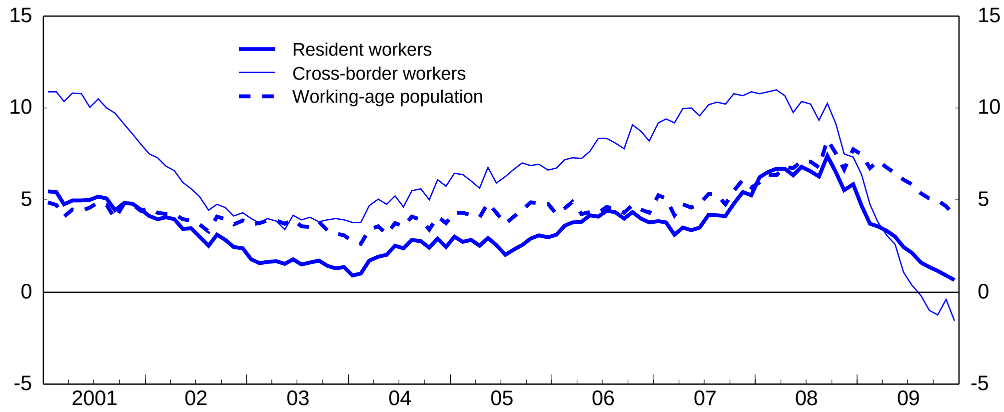
Source: European Commission, *Sustainability Report 2009* and OECD, *Pension at a Glance 2009*.

Making the job market more adaptable will help to boost overall employment and reduce unemployment among residents

Although employment rose strongly in Luxembourg up to 2008, the labour market has been hit hard by the crisis. The unemployment rate has risen to its ever highest level as employment growth has stagnated, despite a large–scale short–time working scheme. The Luxembourg labour market is idiosyncratic: almost half of jobs are held by cross–border workers, who account for a high share of the overall increase in employment in recent years. Despite the crisis, the unemployment rate of resident workers remains lower than in most other OECD countries. However, joblessness was trending up even during the years of strong growth and there are pockets of relatively poor labour market outcomes among the resident population, particularly for the young, the low–skilled, second–earners and older workers. Labour market institutions are relatively rigid and social benefits are generous. Reforms in recent years have been limited. While existing institutions helped to meet Luxembourg's social objectives during its transformation over the past three decades, their impact could be less benign in the future. Some features of these institutions reduce the demand for labour and limit the incentive to work for groups with weak attachment to the labour market.

Figure 4. **Employment growth**

Annual change in thousands

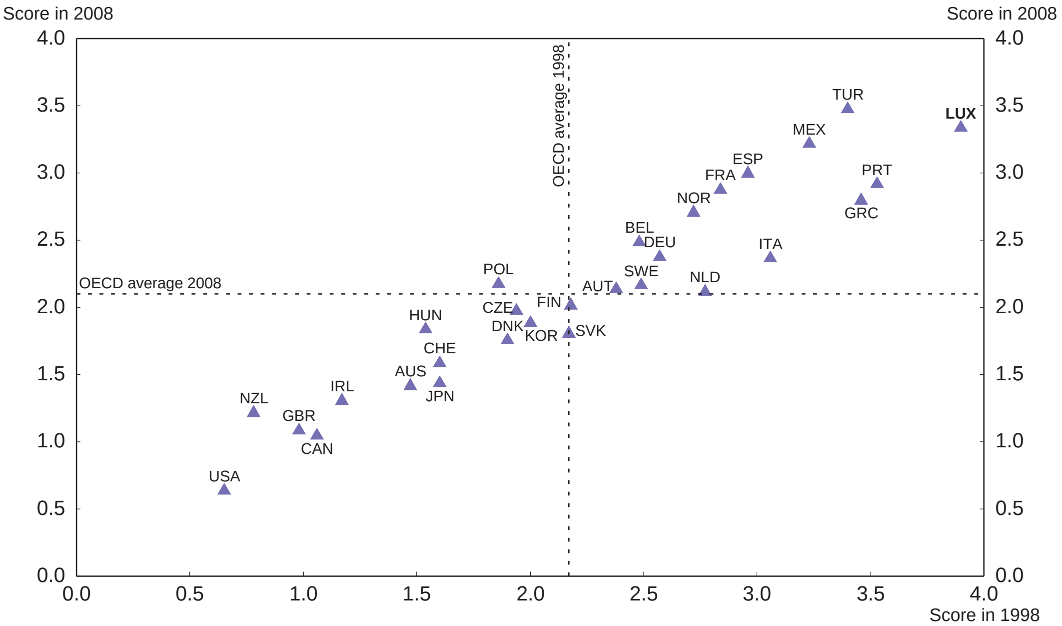


Source: Statec.

Luxembourg's exit strategy from the crisis and high unemployment would be helped by structural changes to increase labour demand, encourage participation rates and prevent entrenched unemployment among residents. Although the system of automatic indexation of wages was temporarily suspended during recent hikes in oil prices, this flexibility did not prevent a loss of competitiveness. There is also evidence that relative real wage adjustment may have been held back by indexation. To deal with these problems, the wage–setting system should be reformed. *As a first step, wages should be indexed to core rather than headline prices. The ultimate objective should be to replace automatic indexation with a system of wage determination more closely linked to productivity.* Employment protection legislation is strict compared to the OECD average, helping to preserve existing jobs but making it more costly to create new jobs and leaving the economy less flexible. *Conditions on collective dismissals and social plans should be eased, and trial periods should be lengthened under regular contracts for those with low salaries and skills.* The minimum wage applies to a large share of the work force. It is high by international comparison, partly reflecting high living costs. This is likely to prevent the creation of some low–skilled jobs. In addition, the high level compared with neighbouring countries makes it attractive for cross–border workers who have lower reservation wages and often better qualifications. *Younger low–skilled residents, who do not have access to social benefits, could gain from jobs created by a lower minimum wage. The setting of the minimum wage should focus on its economic impact. An independent Minimum Wage Council should be introduced to help achieve this. In the short run, the minimum wage should not be adjusted to average earnings but only to inflation* to lower its level relative to wages. These changes should occur alongside reforms to the generous system of social benefits that are designed to improve labour market incentives for resident workers.

Figure 5. **Strictness of employment protection**[1, 2]

Scale index of 0-6 from least strict to strictest regulation



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. For more information and full methodology, see www.oecd.org/employment/protection.

Source: OECD, Labour, Employment protection database.

The employment prospects of resident workers can be improved

Generous social benefits provide high levels of protection but weaken incentives to work by creating inactivity traps that reduce employment among Luxembourg residents. The high level of out–of–work benefits reduces the incentive to find employment, particularly for the low–skilled, while pension and early retirement schemes encourage workers to leave the workforce well before the statutory retirement age. The high rate of exit from unemployment at the end of eligibility suggests that *unemployment benefits should be reduced progressively during the period of entitlement. Eligibility conditions should be tightened for young people without work histories to improve incentives to find work.* On–going social benefits provide high unemployment replacement rates for those with low market wages. *Replacement rates under these benefits should be reduced over time.* A more comprehensive approach to increasing work incentives would be to *consider introducing a system of in–work benefits* to provide social protection while preserving the incentive to work. Support services for the unemployed are under pressure from the increased number of unemployed and there are long–standing weaknesses in the performance of the public employment service (ADEM). *This service should be rationalised and more resources allocated to helping the unemployed find jobs and to supporting activation in line with ongoing reform efforts. All recipients of the minimum revenue (RMG) should be offered integration contracts to increase their incentives to work.* Spending on active labour market programmes has not been systematically evaluated in terms of effectiveness. Expenditures are biased towards temporary job creation schemes and the focus on getting people back to work is weak. Hence, existing *labour market programmes need to be reviewed in terms of their employment outcomes and funding switched to programmes that are cost effective.*

The financial centre has felt the impact of the international financial crisis and faces a more uncertain future

The financial centre's development was instrumental for Luxembourg's public finances and the increase in living standards. The international financial crisis has had a strong impact: reducing bank balance sheets, lowering the value of assets under management, and posing serious difficulties to two cross–border institutions due to problems at the group level. Nevertheless, the direct impact of these factors on activity in the real economy has been limited due to the highly international nature of the financial centre, which has relatively few links to the rest of the economy and is largely foreign–owned. Cross–border co–operation and a specific winding up procedure for banks have allowed effective crisis resolution in the banking sector. As an international financial centre, banks' balance sheets remain extremely large relative to the size of the economy. In addition, the financial centre's role as net liquidity provider creates large exposures to parent banks. Liquidity regulation and supervision have already been strengthened in a qualitative way in line with international best practices. *This should be complemented by a quantitative framework in line with evolving EU guidelines. The payout for the deposit insurance scheme should be speeded up and the scheme moved to an* ex ante *funded basis with risk–based premia*. Following difficulties that arose during the crisis, *the requirement on custodian banks to hold assets placed in their trust needs to be enforced more strictly*. Supervisory resources appear to be adequate and measures have been introduced following the crisis to make supervision more effective, both within Luxembourg and through better oversight of large cross–border banking groups. Supervisory responsibility is split between the financial supervisor and the central bank. *At a minimum, an institutional framework should be established to ensure close and effective co–operation between these bodies. Consideration could be given to creating a single supervisory institution.*

The future prospects of the financial sector, which are central to the outlook for the overall economy, are likely to be affected by changes in the financial industry and the regulatory environment. In addition, the new EU directive on investment funds (UCITS IV) could have a major impact on the way the industry is structured. While the financial centre's very high market share in UCITS funds gives it a powerful advantage, other aspects of the liberalisation could be less favourable, both in terms of the location of funds and the amount of economic activity they bring to Luxembourg. The OECD welcomes Luxembourg's withdrawal of its objections to Article 26 of the OECD convention on information sharing for tax purposes and the rapid implementation of this decision. *The attractiveness of the financial sector would be enhanced by maintaining good framework conditions in terms of education, transport, housing and competitiveness.*

Sustaining high living standards will be supported by on–going education reforms

Living standards are expected to remain high, although potential growth is likely to be lower in the coming years. This underlines the importance of implementing structural policies to increase the resilience and efficiency of the economy. In the long run, a well educated population is vital to ensuring an employable labour force in a rapidly changing world and to maintaining high living standards. The performance of the education system is relatively weak, as measured by PISA scores, and the system has to overcome the intrinsic problem of three languages of instruction in a country with a large immigrant population. The school drop–out rate is high and many young people have difficulties making the transition to the labour market. Major reforms to the organisation of the school system are currently being implemented. These are welcome and are likely to contribute to raising the future living standards of Luxembourg's population.

Competition is weak in the services sector

Stronger competition would help to restore cost competitiveness and increase efficiency. While overall trade openness implies that there is strong competition from companies in neighbouring countries, product market regulation in the domestic market is among the most restrictive in the OECD. It has become increasingly out of line with practice in other countries and preserves many important barriers to competition. While access to the network industries has become easier, state controls on prices and industries is more common than elsewhere and there are heavy administrative burdens on start ups. Many unnecessary restrictions hinder competition in the services sector. For professional services, *reforms should include removing restrictions on advertising and making co–operation between professions easier*. *Minimum or reference prices should be scrapped. An independent regulator should be introduced for the legal profession, the cap on the number of notaries removed, and a special procedure introduced to deal with small claims without the need for legal representation. Restrictions on the number of pharmacies should be ended and pharmacists allowed to offer generics as substitutes, while the sale of some medicinal products by other retailers could be permitted*. In the retail trade, *shop opening hours should be made more flexible*. Once there is effective competition policy in place, *the retail price ceiling for motor fuel should be removed. Restrictive regulations fixing the number of taxis and limiting their ability to compete should be lifted.*

The enforcement of competition policy is weak due to the inadequate resources of the competition authority and its division into two different bodies. No successful case has yet been mounted. *Sufficient resources need to be provided to the competition authority and the two–tier structure replaced with a single authority*. To investigate the operation of markets where competition might be restricted, *the mandate of the new authority should include producing sectoral reports and the government should be obliged to publish a response*.

Housing and transport policies need to meet the demands of Luxembourg's economy

Housing costs are high in comparison with neighbouring regions and some other financial centres, adding to the number of cross–border workers using the transport network. Housing prices have increased as higher demand, boosted by tax distortions, has pushed against supply constraints. The pressure of a large and increasing number of commuters leads to congestion, strain on the infrastructure and environmental problems. This makes Luxembourg a less attractive location for businesses. While the need to build more and denser housing has been recognised for some time, construction has lagged behind these ambitions. Housing supply is constrained by cumbersome regulations and low property taxes, which encourage the hoarding of building plots. *The planning system should be overhauled to make it easier to build new housing*. In addition, the tax system is very favourable to owner occupation, with low effective property taxes, mortgage interest deductibility, favourable taxation of capital gains on principal residences and interest–rate subsidies. Given limited supply, this largely acts to make housing more expensive. *Consideration could be given to reforming these tax subsidies*. The Transport Sector Plan (PST) sets out a multi–year programme to expand and upgrade the infrastructure with the aim of substantially increasing the public transport share in commuting. *These infrastructure investments should continue*. In addition, *a system of congestion charging should be considered for key parts of the road network* to encourage the shift towards public transport and to improve the efficiency of the use of the existing infrastructure.

Reducing greenhouse emissions will be a major challenge

Luxembourg has the highest *per capita* CO_2 emissions in the OECD and is committed to making the largest proportional reductions of any EU country. A number of measures have already been taken, including through the National Energy and Efficiency Action Plan. It aims to achieve around half its targets through improved residential energy efficiency. The EU Emission Trading Scheme covers some large polluters. However, the majority of emissions come from the transport sector. The bulk of motor fuels in Luxembourg is sold to cross–border residents, foreign demand created by a combination of commuting and low fuel taxes compared with neighbouring regions. Fuel taxes have already been raised through the so–called "Kyoto tax", together with changes in car taxes. *Taxes on motor fuels should be increased further* to help achieve Luxembourg's emissions targets. While much of the effect would be to switch fuel purchases back across the borders, there would be a net gain as this would raise the effective price in the region as a whole. This could be less costly for Luxembourg than reducing its domestic emissions in other ways.

Chapter summaries

Chapter 1. Recovering from the crisis

Luxembourg has experienced a severe recession as the result of the international financial crisis. Output contracted sharply and unemployment has risen. Luxembourg's economy was heavily exposed to the downturn in world trade and the financial centre has been strongly affected. However, policy support from accommodative euro area monetary policy and a fiscal stimulus package helped stabilise the economy. While recovery is now underway, demand is likely to be held back by a weakness in competitiveness, necessary fiscal consolidation and lower potential output. Growth in the coming years is likely to be lower than before the crisis, although living standards will remain high. The fiscal position has deteriorated rapidly due to a sharp fall in tax receipts from the financial sector, substantial fiscal stimulus measures and rising spending. A consolidation plan has been outlined. This should be implemented and could even be more ambitious, given long–run spending pressures. The consolidation effort would be enhanced by a more detailed, multi–year plan based on limiting current expenditures. Strengthening the budgetary and fiscal institutions would also help. The main challenge for fiscal sustainability is very large future pension costs, with the effects of population ageing amplified by the age profile of cross–border workers. While substantial reserves are being accumulated, the high level of pension benefits needs to be contained through a comprehensive reform of the pension system. The required fiscal consolidation provides an opportunity to improve public sector efficiency, modernise public management and increase value for money. Improving the control of costs in the health system would increase efficiency.

Chapter 2. Achieving sustainable improvements in living standards

Luxembourg has achieved rapid and sustained growth over the past 25 years and living standards are the highest in the OECD. However, following the crisis, it now faces the possibility of weaker performance in the years to come even if living standards will remain high. This underlines the importance of structural policies to help boost growth and sustain high incomes. Apart from measures to improve the functioning of the labour market and raise public sector efficiency, there are a number of policy priorities. Education performance is relatively weak: it does not match the demand for high–skilled workers and makes it harder for residents to find jobs. Major reforms now underway to improve the education system are welcome. Product market regulations are highly restrictive of competition, particularly for professional services and in the retail sector. This leads to high prices and inefficiency. The weak enforcement of competition policy is due to inadequate resources and the fragmented structure of the competition authorities. Housing costs are high by comparison with the surrounding region and other financial centres. This contributes to large flows of commuters. While increasing housing supply is recognised goal, this has been frustrated by policy barriers that restrict house building. At the same time, housing demand is boosted by tax subsidies. The transport infrastructure is being upgraded and extended. However, the existing network could be used more efficiently through user charges. Luxembourg has the highest per capita CO2 emissions in the OECD. It is committed to making large reductions, and measures to increase energy efficiency are being put in place. The key problem, however, is large sales of motor fuels to people who live in the surrounding countries. Car taxes and fuel duties have increased but there is scope to go further.

Chapter 3. Making the labour market work better

Rapid economic growth over the past two decades has substantially increased employment in Luxembourg, which has largely been met by in–flows of cross–border workers and, to a lesser extent, immigration. Unemployment has remained low compared to other European countries. These significant social changes have been absorbed without substantially widening income disparities, facilitated by the generous welfare system made affordable by the strong economy. However, this favourable overall picture masks weaknesses in the design of labour market institutions and social transfers that reduce incentives to work for resident workers. Despite the strong economy, this has resulted in lower employment rates for certain groups of residents, notably those who are second–earners, younger or older, or from poorer socioeconomic backgrounds. Furthermore, the incentives provided by existing labour market institutions could make adjustment to changed economic prospects more difficult. The functioning and adaptability of the labour market could be improved without undermining social cohesion through a range of related measures. This could include aligning minimum wage adjustments more closely with economic conditions, which could be achieved through a Minimum Wage Council, and softening employment protection legislation. To raise incentives of residents, social benefits should be decoupled from average wages, and social transfers could be reoriented towards in–work social benefits.

Chapter 4. The Luxembourg financial centre and the international financial crisis

Over past decades, Luxembourg has emerged as a major international financial centre. This has been crucial to the development of its economy and the financial sector has come to play a large role in economic activity, employment and government revenues. The financial centre is specialised in the management of interbank liquidity for international cross–border banks and asset management activities. The global financial crisis has had a strong impact on the financial sector with a substantial contraction of banks' balance sheets, mostly related to lower interbank lending, and a fall in the value of assets under management due to the drop in equity prices. Two large cross–border banks came under severe pressure and were supported by the authorities in Luxembourg and their home countries, while three small subsidiaries of foreign banks were put into administration. However, the impact on the wider Luxembourg economy may be more limited than anticipated. The crisis had a big direct impact on financial activity and tax receipts, but the fall in financial sector employment has been modest so far. The scale of support to the banking sector has been manageable. Despite a very large financial sector in relation to the overall economy, the wider effect has been muted by the limited links between financial centre activities and provision of credit to the local economy, the role of the banking centre in managing liquidity rather than extending credit to the non–financial sector, and high foreign ownership of the main institutions. Nevertheless, the crisis has underlined some of the inherent risks associated with activities in the financial sector. In particular, it is important that the regulation of liquidity is effective and cross–border supervision works well. The resolution mechanism for banks appears to have worked effectively, although there is scope to strengthen the deposit guarantee scheme. In the aftermath of the financial crisis, there will be significant changes in the financial industry and the international regulatory environment. In addition, a new EU directive on investment funds (UCITS IV) is likely to lead to some restructuring of asset management activities. It will be a significant challenge for Luxembourg to adapt to these changes and ensure that its financial sector remains a success and continues to develop.

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Luxembourg were reviewed by the Committee on 12 April 2010. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 21 April 2010.

The Secretariat's draft report was prepared for the Committee by Sebastian Barnes, Artur Radziwill and Jeremy Lawson under the supervision of Piritta Sorsa. Research and editorial assistance was provided by Agnès Cavaciuti, Ane Kathrine Christensen and Isabelle Duong.

The previous Survey of Luxembourg was issued in June 2008.

Further information

For further information regarding this overview, please contact:

Piritta Sorsa, e-mail: piritta.sorsa@oecd.org; tel.: +33 1 45 24 82 99; or
Sebastian Barnes, e-mail: sebastian.barnes@oecd.org; tel.: +33 1 45 24 94 21; or
Artur Radziwill, e-mail: Artur.radziwill@oecd.org; tel.: +33 1 45 24 93 56.

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