INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/373

REPUBLIC OF SAN MARINO

November 2023

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SAN MARINO

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 2023 Article IV consultation with the Republic of San Marino, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 17, 2023 consideration of the staff report that concluded the Article IV consultation with the Republic of San Marino.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 17, 2023, following discussions that ended on September 29, 2023, with the officials of the Republic of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on October 31, 2023.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of San Marino.

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 2023 Article IV Consultation with the Republic of San Marino

FOR IMMEDIATE RELEASE

Washington, DC – November 22, 2023: On November 17, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino.

Despite external shocks and higher interest rates, growth has remained resilient in San Marino. Prudent policies and access to international capital markets increased policy buffers to healthy levels. Robust external demand until recently boosted manufacturing and the tourism sector. With the economy booming, employment reached record levels. The recovery has so far been resilient to headwinds from higher inflation, tightening financial condition and weak external demand. However, these factors and heightened global uncertainty will weigh on activity that is expected to slow down. Inflation is forecasted to remain elevated but declining in line with Italian trends.

The successful Eurobond rollover in May 2023 significantly reduced short-term risks improving domestic liquidity and supporting confidence. Downside risks relate to the weakening of external conditions, and further global monetary tightening while domestic risks concentrate on political uncertainty due to elections next year and remaining vulnerabilities in the financial sector. The underlying strength of the manufacturing sector and healthy private sector balance sheets provide some upside risks to the baseline.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They welcomed that San Marino has shown remarkable resilience to recent external headwinds. Directors, however, noted that growth is expected to slow toward its potential, in the context of tightening financial conditions, weak external demand, and heightened uncertainty. Noting that risks are tilted to the downside, Directors emphasized the importance of preserving macroeconomic stability, restructuring the financial sector, and enhancing potential growth.

Directors welcomed the improved fiscal position and underscored that further efforts are needed to reduce debt to below 60 percent of GDP by 2028. Important measures include broadening the income tax base, introducing a VAT, and improving the efficiency of public spending, by strengthening public financial management and better targeting social programs. Directors recommended continued prudent wage and pension indexation and highlighted that

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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] At the conclusion of the discussion, the Deputy Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

further reforms are needed to ensure the long-term sustainability of the pension system. They also stressed the need to develop and communicate a medium-term fiscal and debt strategy.

Directors recognized the considerable progress made in restructuring and consolidating the banking sector, but highlighted that vulnerabilities remain especially in a higher interest rate environment. Noting the elevated nonperforming loans (NPLs), high operational costs, and weak capitalization in some banks, Directors stressed the need to improve banks' profitability and capitalization, while avoiding forbearance and limiting fiscal risks. Directors welcomed the progress in implementing the authorities' strategy to reduce NPLs through an Asset Management Company (AMC) and calendar provisioning. They emphasized the need for credible capitalization plans to promptly address any undercapitalization that arises from the implementation of the strategy. Directors also underscored the importance of a strong governance structure for the AMC to reduce implementation risks. They encouraged efforts to improve and align the bank resolution framework with European standards.

Directors recommended strengthening the central bank's financial position to safeguard its independence and support financial sector stability. They also encouraged measures to strengthen the AML/CFT framework.

Directors underscored that structural reforms are critical to support long-term growth. They highlighted that the Association Agreement with the EU would enhance economic integration and attract foreign investments. Directors also stressed that further efforts are needed to increase the flexibility of the labor market, preserve the financial soundness of the state-owned utility company, and improve the insolvency framework. Noting that data provision remains broadly adequate for surveillance, Directors encouraged further efforts to improve the quality and the frequency of data.

San Marino: Selected Economic Indicators, 2018–23

	2018	2019	2020	Est. 2021	Proj. 2022	Proj. 2023
Activity and Prices						
Real GDP (percent change)	1.5	2.0	-6.8	14.2	5.0	2.2
Unemployment rate (average; percent)	8.0	7.7	7.3	5.2	4.3	4.0
Inflation rate (average; percent)	1.2	0.5	-0.1	2.1	5.3	5.9
Nominal GDP (millions of euros)	1,402	1,444	1,352	1,569	1,693	1,836
Public Finances (percent of GDP) 1/						
Revenues	23.0	22.3	21.6	20.7	22.7	20.5
Expenditure	24.5	22.4	59.2	37.1	22.3	22.7
Overall balance	-1.6	-0.1	-37.6	-16.4	0.4	-2.2
Government debt (Official)	30.1	25.9	71.6	63.0	71.7	67.6
Public debt 2/	57.2	57.4	71.6	81.3	76.7	72.2
Money and Credit						
Deposits (percent change)	...	-11.9	3.1	3.2	1.7	...
Private sector credit (percent change)	-6.7	1.0	-4.1	-10.8	0.0	...
Net foreign assets (percent of GDP)	124.8	123.5	141.4	137.3	122.8	...
External Accounts (percent of GDP)						
Current account balance	-1.9	2.0	2.8	6.5	8.0	3.8
Gross international reserves (millions of euros)	248.1	410.6	636.7	842.4	533.0	513.0
Financial Soundness Indicators (percent) 3/						
Regulatory capital to risk-weighted assets	12.3	9.5	10.7	14.4	14.6	...
NPL ratio	50.7	58.9	61.1	59.0	53.1	...
NPL coverage ratio	58.2	63.6	64.4	65.0	69.8	...
Return on equity (ROE)	-17.2	-74.6	-7.7	3.8	3.8	...
Liquid assets to total assets	15.2	18.0	19.2	27.3	26.5	...
Liquid assets to short-term liabilities	27.6	32.7	33.1	44.0	43.1	...

Sources: International Financial Statistics; IMF Financial Soundness Indicators; Sammarinese authorities; World Bank; and IMF staff.

1/ For the central government.

2/ Central government (official) debt plus Social Security Fund and BNS debt.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

October 31, 2023

KEY ISSUES

Context. The global financial crisis and international efforts to address preferential tax regimes exposed the vulnerabilities of San Marino's oversized financial sector servicing nonresidents. While the banking system entered a deep crisis in 2008 and continues to struggle, the nonfinancial sector has experienced a recovery underpinned by cost-competitiveness and strong corporate balance sheets. More recently, prudent fiscal policies, access to international capital markets and favorable external conditions improved the public finances and boosted confidence. As a result, the economy has been remarkably resilient throughout the pandemic and Russia's invasion of Ukraine. Despite volatile financial conditions, the government was able to rollover the Eurobond maturing next year. However, San Marino is a microstate subject to very high volatility and financial sector vulnerabilities remain, suggesting that larger-than-usual fiscal buffers are needed.

Outlook and risks. High inflation and higher interest rates are eroding real income and putting pressure on firms' healthy level of profitability. This, combined with weakening global demand will affect economic activity, that while still positive, is decelerating in 2023. The labor market will remain tight, and the external position is expected to remain strong. The fiscal position will continue to improve from a weak starting position pre-covid driven by windfall revenues from high inflation and prudent wage and pension indexation. Downside risks are mostly external related to the slowdown in Europe and the war but there are domestic political risks related to elections in 2024.

Policy discussions. Given San Marino's recent access to international capital markets and associated market discipline, the main priority is to advance the NPL securitization in a credible way that avoids forbearance and minimizes fiscal risks. This process and calendar provisioning can reveal capital needs at some banks that will need to be promptly addressed. A viable banking system will also require strengthening cost-efficiency and improving the quantity and quality of capital. To continue strengthening the fiscal position to levels consistent with San Marino's characteristics, further fiscal consolidation is needed. More generally, fiscal policy needs to have a medium-term perspective that should include the development of a debt management strategy. Finally, structural reforms to further liberalize the labor market and efforts to advance the EU's association agreement are critical to increase the flexibility of the economy, preserve macroeconomic stability and increase the growth potential of San Marino.

Approved By	
Helge Berger (EUR) and Geremia Palomba (SPR)	Discussions were held on September 16–29, 2023, in San Marino. The team comprised Mr. Gracia (head), Messrs. Cabezon and Qu (all EUR). Mr. Garrido and Ms. Tanaka (LEG) joined virtually. Mr. Spadafora (OED) participated in the discussions. The team met with the Heads of State, Secretaries of State for Finance and Budget, Foreign Affairs, Labor, Industry, Health and Social Security, Tourism, Central Bank President, other government and central bank officials, private sector representatives, and social partners. Ms. Fisher and Mr. Velazquez-Romero (all EUR) assisted the mission from headquarters.

CONTENTS

ANNEXES

CONTEXT: RECOVERY IN MANUFACTURING AND PRUDENT POLICIES PROVIDED RESILIENCE

1. **The global financial crisis (GFC) and international efforts to address preferential tax regimes triggered a major crisis that ended San Marino's banking business model.** This was based on an oversized financial sector servicing nonresident. The banking crisis had major spillovers on the nonfinancial sector that were magnified by the blacklisting of San Marino as a jurisdiction with a preferential tax regime during 2010-14. The crisis lasted from 2008 to 2014 when the financial sector lost 80 percent and the nonfinancial sector lost 15 percent of the value added.

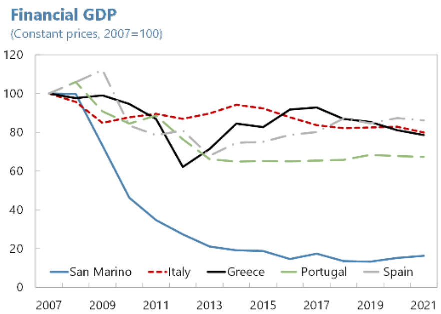
2. **While the financial sector's value added never recovered, the nonfinancial sector started a recovery in 2014 underpinned by cost-competitiveness in labor and strong balance sheets (Annex V).** The financial sector's value added remains at 20 percent of the pre-GFC level. The sector has gone through a painful deleveraging process that continues to this day—assets have declined from above 600 percent of GDP in 2008 to below 300 percent currently with 64 percent of GDP representing nonperforming assets. The nonfinancial sector bottomed out in 2014 and started a recovery exceeding its pre-GFC level in 2022. Labor cost started to decline relative to Italy in 2014, and the downward trend persisted, supported by some measures liberalizing the labor market. While access to local credit was limited, exporting companies had access to Italian banks facilitating investment and allowing an orderly deleveraging. Investment was also financed by retained earnings, especially in the profitable manufacturing sector. Thus, San Marino's exporting sector, integrated in one of the most dynamic industrial regions of Italy, was in a strong competitive position when the pandemic hit, contributing to its remarkable resilience.

3. **Prudent policies, access to international capital markets and favorable external conditions increased policy and macroeconomic buffers to healthy levels.** Accessing international capital markets in 2021, boosted confidence and helped avoid major disruptions given a weak fiscal position and low system-wide liquidity. This combined with an early reopening of the economy from pandemic-related lockdowns, increasing external demand post-pandemic, nearshoring, and supply disruptions of export competitors, resulted in buoyant orders, full employment, and a strengthening of the fiscal position. The surge in energy prices after Russia's invasion of Ukraine—milder in San Marino than in neighboring countries—and the increase in global interest rates, have not derailed the strong economic performance so far.

4. **The increased volatility associated with microstates as well as remaining financial sector vulnerabilities suggest that larger-than-usual fiscal buffers are needed.** San Marino has no physical borders with Italy which implies free flow of goods and most services as well as labor. At the same time, as a euroized economy it has limited tools to cope with shocks. Thus, a strong fiscal position is needed to play a countercyclical role.

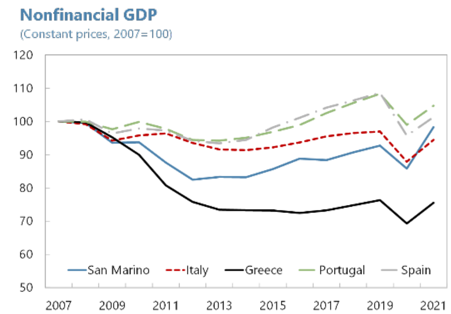
Figure 1. Context: San Marino Resilience

Financial GDP loss was not reversed…



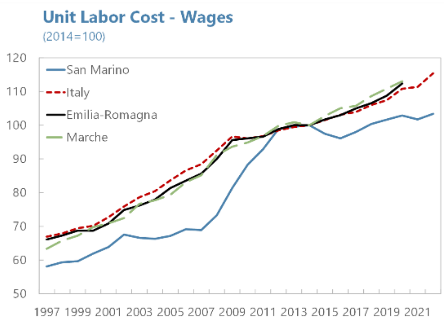
Sources: Haver Analytics, Fitch, country authorities and staff estimates.

while nonfinancial GDP recovered to pre-GFC level.



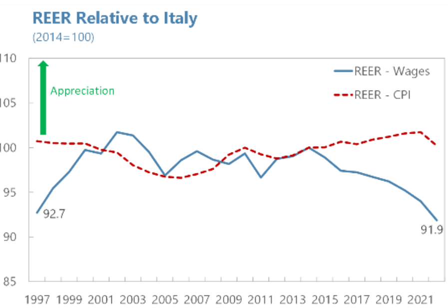
Sources: Haver Analytics, Fitch, country authorities and staff estimates.

Labor costs become more competitive starting in 2014….



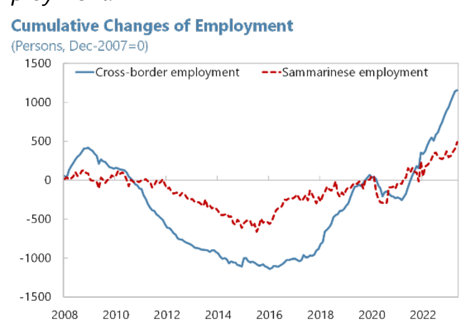
Sources: Sanmarinese authorities, Italian authorities, and IMF staff estimates.

and so do real exchange rate.



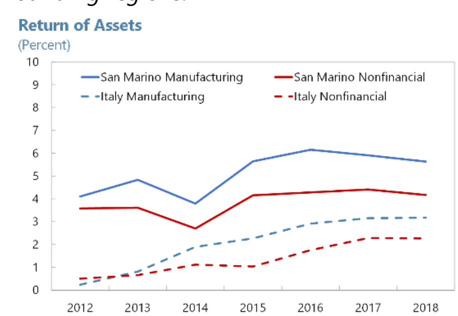
Sources: IMF staff estimates.

Labor market reforms supported cross-border employment.



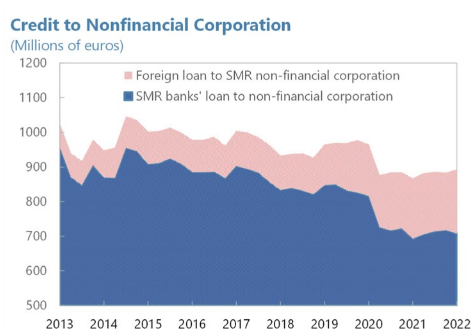
Sources: Country authorities

while San Marino firms are more productive than surrounding regions.



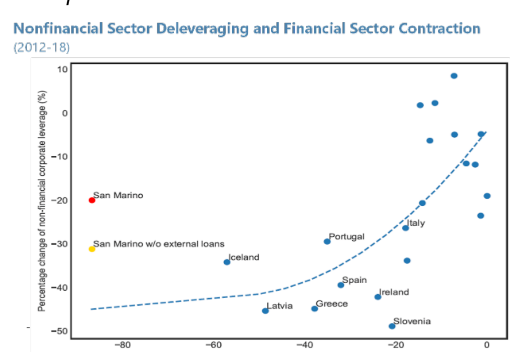
Sources: Orbis and country authorities

Foreign loan alleviates credit crunch from domestic banks…



Sources: BIS and country authorities.

External credit facilitates a more orderly deleveraging than expected.

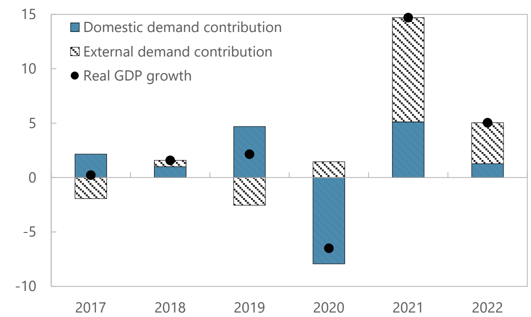


Sources: Country authorities and staff estimates.

RECENT DEVELOPMENTS: STRONG ECONOMIC MOMENTUM DESPITE SHOCKS

5. The strong post-pandemic recovery has been resilient to increases in energy prices and interest rates so far. A robust recovery supported by a strong external demand started in 2021 with real GDP growing 14.2 percent (Box 1). The strong recovery of the Italian economy combined with supply-chain disruptions and nearshoring efforts in trading partners, boosted manufacturing exports. In addition, less restrictive lockdowns and the early removal of covid-restrictions unlocked tourism and domestic consumption. The increase in energy prices and associated negative terms-of-trade shock was less severe than elsewhere in Europe. Also, strong balance sheets and healthy profitability allowed exporting businesses to cope with the interest rate increases and keep hiring workers.

Real GDP Growth
(Percent)



Sources: Sammarinese authorities; and IMF staff estimates.

Box 1. Factors Behind the Strong Real GDP Growth in 2021

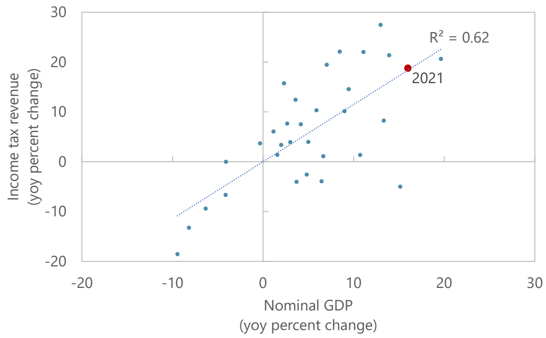
GDP Revisions for 2021

	Nominal growth (Percent)	Real growth (Percent)	Deflator growth (Percent)
2022 Article IV estimates	9.2	8.3	0.9
2023 Article IV	16.0	14.2	2.1

- GDP growth in 2021 is consistent with 20 percent manufacturing gross value-added growth and 18 percent income tax revenue growth.
- Growth outstripped the surrounding Emilia-Romagna and Marche regions (7-7.5 percent) due to less restrictive mobility-restrictions during the pandemic that were lifted earlier in 2020Q3. These factors are reflected in the two countries' PMI which deviated since 2020Q3.
- This volatile growth, while exceptional for San Marino, is consistent with other micro economies in Europe that recorded similarly high growth in 2021.

Box 1. Factors Behind the Strong Real GDP Grown in 2021 (Concluded)

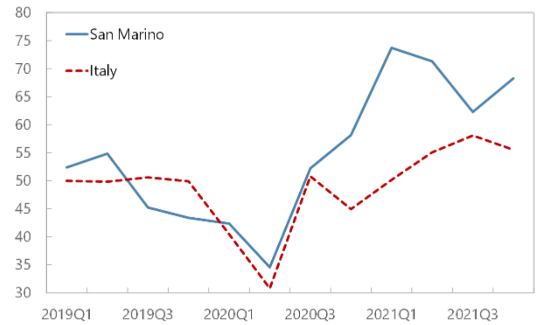
Nominal GDP and Income Tax Revenue, 1990-2021



Sources: Sammarinese authorities; and IMF staff estimates.

PMI

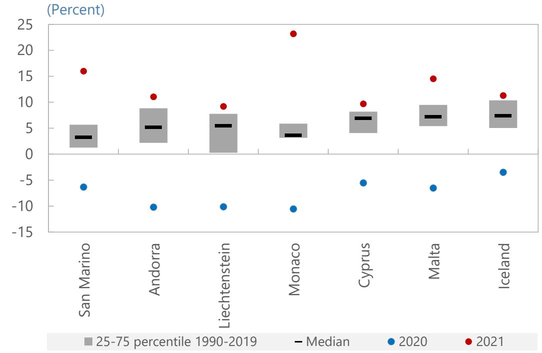
(Percent)



Sources: Haver analytics and country authorities.

Nominal GDP Growth

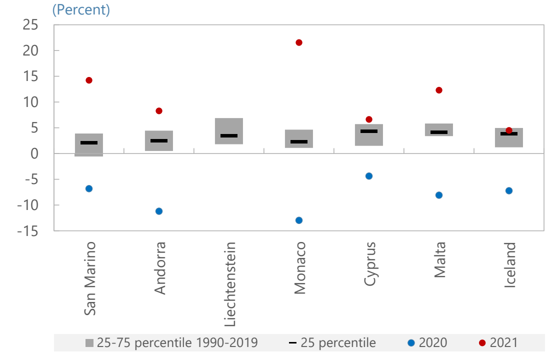
(Percent)



Sources: IMF WEO, country authorities, and IMF staff estimates.

Real GDP Growth

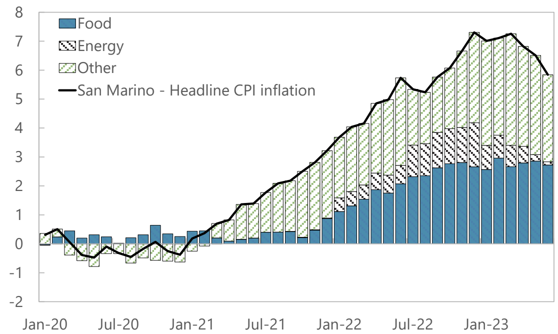
(Percent)



Sources: IMF WEO, country authorities, and IMF staff estimates.

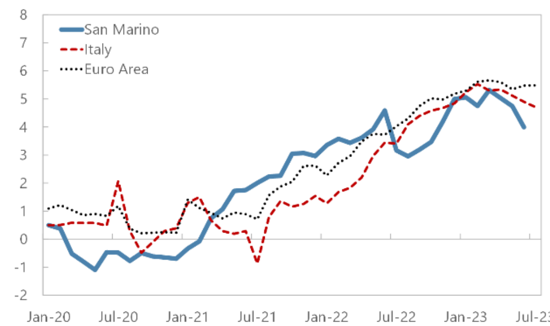
6. **Inflation, largely imported, soared and it remains high eroding real incomes, but second round effects have been moderate.** Headline inflation accelerated to 7 percent at end-2022 and decelerated moderately to 5.8 percent by June 2023. Inflation is largely imported driven by Italy—in particular, food prices—and utility tariff increases. In 2022, households' natural gas and electricity prices increased 44 and 46 percent respectively well below increases in Europe. As a result, real households' incomes were affected and contained domestic consumption growth that remains positive. Core inflation exhibited greater persistence driven by imported factors. In contrast, domestic drivers of second round effects have been moderate as wages grew significantly below inflation last year (2.5 versus 5.3 percent). Private sector collective wage agreement suggests similar moderate increases this year with public wages following private sector dynamics.

Headline Inflation
(Percent, yoy)



Sources: Sammarinese authorities and IMF staff estimates.

Core Inflation
(Percent, yoy)



Sources: Sammarinese authorities; Eurostat; and IMF staff estimates.

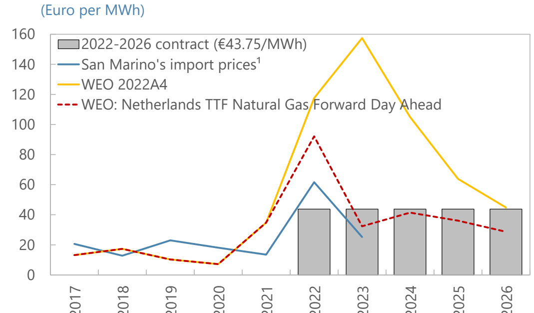
7. **Energy tariffs increased less than elsewhere in Europe without public subsidies due to a timely long-term gas contract and successful hedging operations for electricity.** Tariff increases and hedging contained losses in the state-owned utility company (AASS). Given elevated volatility of energy prices, the model of constant tariffs for many years complemented with hedging operations became unviable. Thus, a new model based on monthly tariff adjustments indexed to Italian wholesale energy prices has been introduced. Tariffs are further adjusted every six months to prevent losses in AASS. In addition, by early 2023, the authorities decided to exit the long-term gas contract for 2023-25 at favorable conditions anticipating that prices would decline below the contract price. While the new tariff structure ensures AASS financial sustainability, there have been some implementation challenges including government interventions and operational issues.

Tariff Adjustments[1]
(Percent)

	Jan-22	Jul-22	Dec-22	**2022 Jan-Dec**	Jan-23	Apr-23	**2023 Jan-Jun**
Natural Gas							
Households	30	30	0	**69**	0	3	**-10**
Corporations	36-46	81	0	**157**	0	12	**-1**
Electricity							
Households	30	0	68	**116**	-39	-9	**-56**
Corporations	40	0	133	**227**	-44	-6	**-58**

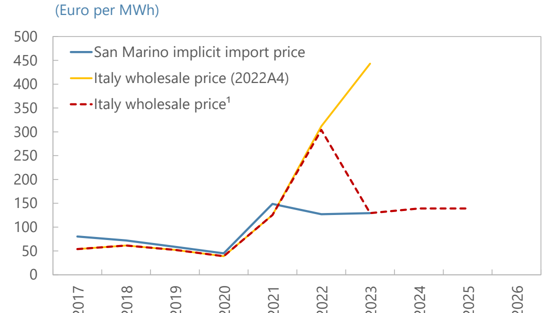
Source: San Marino Regulatory Authority for Public Services; and IMF staff estimates.
1/ Referes to the energy component of overall tariffs.
Grey shaded areas represent indexed tariffs.

Natural Gas Prices
(Euro per MWh)



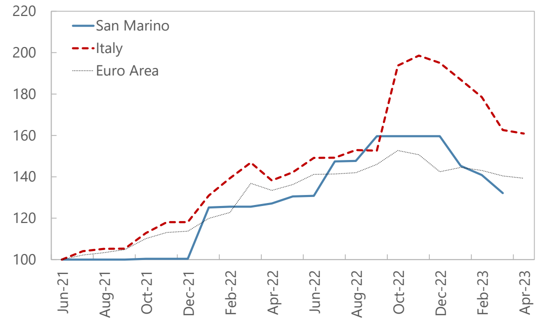
[1]The price is higher than the contract as the contract covers 80 percent of consumption.
Sources: IMF staff estimates.

Electricity Prices
(Euro per MWh)



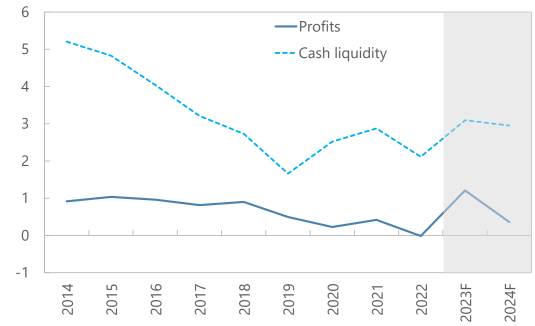
[1] Reflects futures for 2023, and 2024-25 as Oct. 9, 2023.
Sources: Sammarinese authorities, GME, and IMF staff estimates.

CPI - Energy
(Dec-2020=100)



Sources: Eurostat; Sammarinese Statistics Office; Istat; and IMF staff estimates.

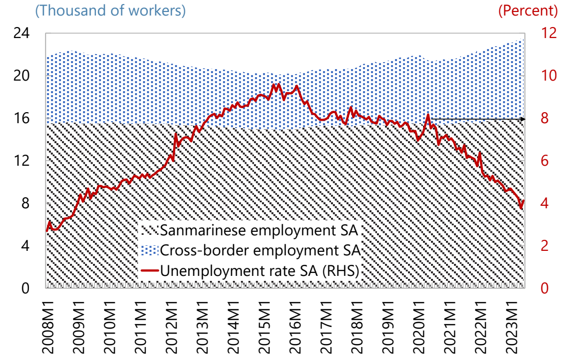
AASS Profits and Cash Liquidity
(Percent of GDP)



Sources: AASS, and IMF staff estimates.

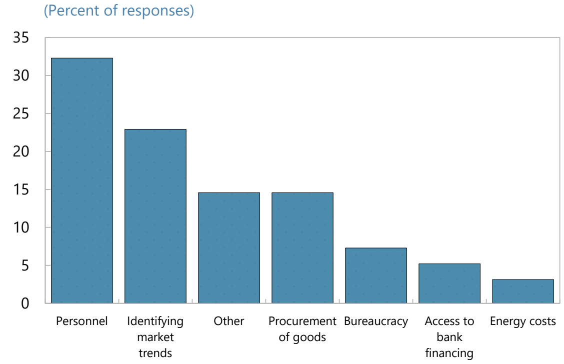
8. **With a booming economy, the labor market remains tight with most unemployment being structural**. The unemployment rate declined to 3.5 percent in May 2023, the lowest since the GFC, amidst continued skilled-labor shortages that were partly alleviated by cross-border workers. Despite heightened uncertainty and higher global interest rates, employment has continued to increase so far this year across all sectors. Furthermore, the lack of skilled labor has become so entrenched that manufacturing firms are willing to retain firm-specific human capital even if the economy weakens, which suggests a resilient labor market going forward.

Employment and Cross-border Workers
(Thousand of workers) (Percent)



Sources: Sanmarinese authorities, and IMF staff estimates.

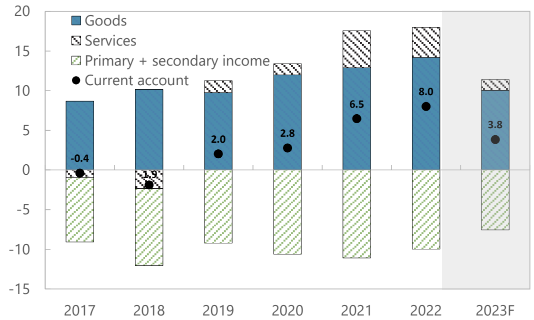
Main Challenges for Business during 2022H2
(Percent of responses)



Sources: ANIS.

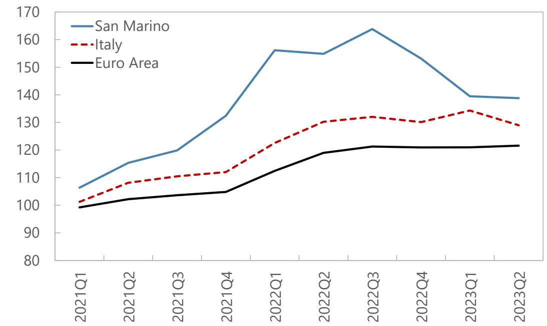
9. **Strong external demand and a competitive manufacturing sector resulted in a strong external position.** With a more moderate energy shock, the term-of-trade deteriorated less than trading partners and helps explain the improvement in the trade balance last year. Furthermore, manufacturing exports surged due to a strong pre-covid competitive position as past moderate wage growth helped recover the competitiveness lost after the GFC. Strong export performance has been further supported by international supply chain disruptions, while tourism recovered quickly to pre-covid levels. Thus, the current account surplus climbed to 8 percent of GDP in 2022 (from 6½ percent). Despite the robust current account, international reserves shrank (€309 million) as funds were reallocated abroad in search for yields. Overall, the external position in 2022 was broadly in line with fundamentals and desirable policies (Annex III).

Current Account
(Percent of GDP)



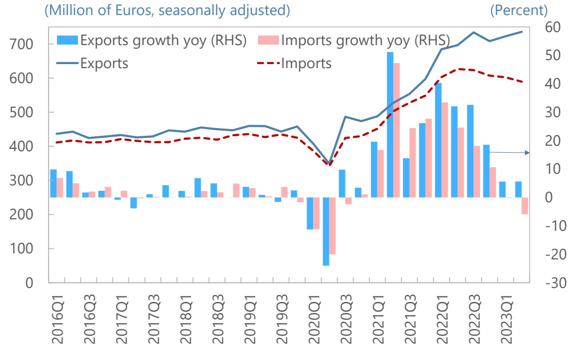
Sources: Country authorities; and IMF staff estimates.

Manufacturing Exports
(2019=100, seasonally adjusted)



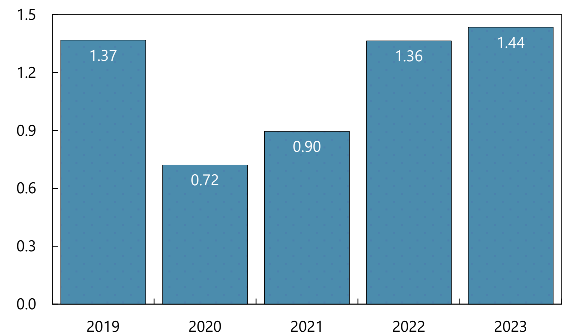
Sources: Sammarinese authorities, Istat, ECB, and IMF staff estimates.

Goods Foreign Trade
(Million of Euros, seasonally adjusted) (Percent)



Sources: Sammarinese authorities, and IMF staff estimates.

Number of Visitors from Januanry to August
(Millions of people)



Sources: Country authorities; and IMF staff estimates.

10. The fiscal position has strengthened from a weak starting point, as the government saved revenue windfalls and managed spending prudently, a trend that continues this year. The structural balance excluding one-offs and bank supports improved by 1 percent of GDP in 2022 while the primary balance net of bank support improved by 5 percent of GDP. Strong economic growth and inflation have boosted tax revenues—the windfall from inflation is estimated around 0.3 percent of GDP—and an ML-related one-off asset confiscation increased nontax revenues. Also, spending was contained as wages and pensions were indexed below inflation, support to the private sector and AASS was lower than expected, and one-off capital expenses related to purchase of office space were delayed. The 2023 budget continues this trend with moderate indexation expected to generate further savings of 1 percent of GDP—0.3 percent from wages and 0.6 percent from pensions. The one-off purchase of office space will offset some of these savings. All in all, while the primary balance shows a deterioration, the underlying structural position is expected to improve.

Central Government: Selected Fiscal Indicators, 2021-23
(Percent of GDP)

	2021	2022		2023	
		2022A4[1]		2022A4[1]	
Revenues	20.7	20.1	22.7	18.3	20.5
Tax revenue	16.0	16.1	17.4	14.4	16.4
Nontax revenue	4.7	4.0	5.3	3.9	4.2
Expenditures	37.1	23.2	22.3	21.2	22.7
Primary expenditure expenses net of bank support	22.8	21.2	19.7	18.9	19.7
Interest payments	1.9	1.4	1.3	1.4	2.1
Bank support[2]	12.3	0.6	1.2	0.8	0.9
Overall balance	-16.4	-3.1	0.4	-2.8	-2.2
Primary balance net of bank support	**-2.2**	**-1.1**	**3.0**	**-0.6**	**0.8**
Structural primary balance net of bank support[3]	-0.5	-1.1	0.6	-0.6	0.7
Temporary factors affecting primary balance	-1.6	0.0	2.4	0.0	0.2
Cyclical tax revenue	-0.2	0.9	1.5	0.0	0.8
One-off asset confiscation	0.5	0.0	0.9	0.0	0.0
One-off expenditures[4]	-1.9	-0.9	0.0	0.0	-0.6
Public debt	**81.3**	**78.3**	**76.7**	**83.5**	**72.2**

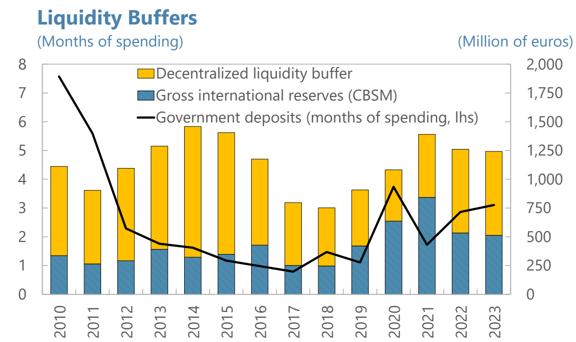
Sources: IMF staff estimates.
1/ Normalized by revised GDP due to the large revision of 2021.
2/ Includes the government repayment of BCIS liabilities to the pension fund.
3/ Corrects for cyclical tax revenue, and one-off revenues and spending.
4/ Includes the one-off purchase of office space (0.6 percent of GDP) in 2023.

11. The successful issuance of the Eurobond has reduced fiscal risks significantly. San Marino issued its' second Eurobond in history in May 2023 with a higher interest rate and moderately extended maturity reflecting market conditions. At the same time, the central bank of San Marino (CBSM) extended the €100 million repo line with the ECB. In addition, ex-BNS[1] bonds (issued to uninsured depositors of the liquidated BCIS) for €142 million were converted into government bonds with extended maturities, implying haircuts of 22-26 percent in net present value. These operations reduced the gross financial needs (GFN) for the next 3 years and supported domestic liquidity. However, GFN risks are concentrated in 2027, when they will reach 23 percent of GDP.

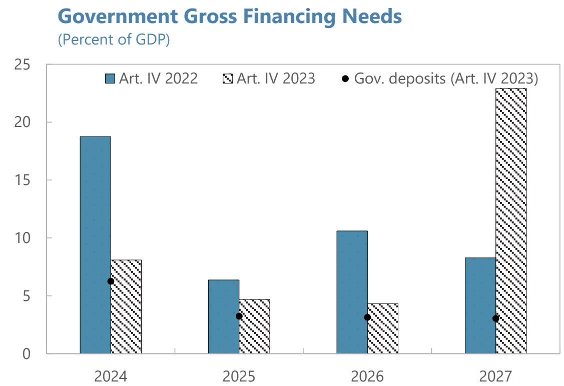
Eurobond Issuances

	2021 Issuance	2023 Issuance
Amount (million Euros)	**340**	**350**
By-back (million Euros)	...	287
Maturity (years)	3	3¾
Interest rate (percent)	3.25	6.50
Risk free rate	-0.70	2.26
Sovereign spread	3.95	4.24

Source: IMF staff estimates.



Sources: CBSM, MoF and IMF staff estimates.
Note: Decentralized liquidity buffer includes cash, deposits and loans available within 7 days, and securities that can be readily converted to cash but does not include deposits at CBSM and Sammarinese banks.

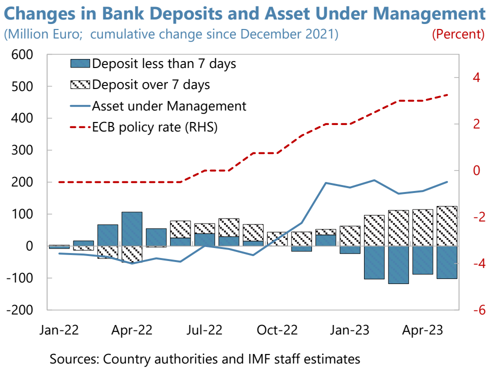


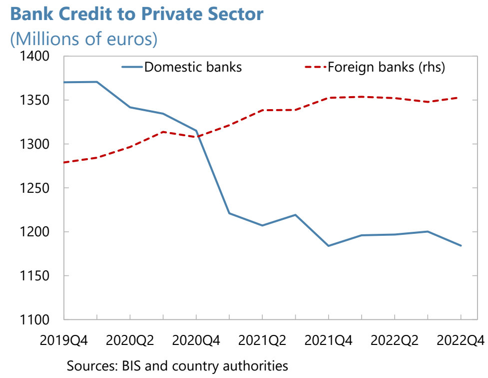
Sources: Country authorities; and IMF staff estimates.

12. Domestic credit and deposits have been stable despite higher interest rates and the financial turbulence in early 2023. Bank deposits increased 1.4 percent (yoy) in 2022, but this was reverted in 2023Q1, as savers, looking for higher yields, moved funds to asset management portfolios which increased 10 percent in 2022. Domestic banks also moved excess liquidity abroad from the central bank. Nevertheless, banks' deposits at the central bank have stabilized by end-2022. Overall, banks' liquidity declined marginally since end-2021 and the financial turbulence earlier in the year had no appreciable impact.

13. The banking system continues a gradual and slow deleveraging. Credit growth has been virtually zero over the last few years despite a booming economy while nonperforming loans (NPLs) remained very high at 53 percent of gross loans (26.5 net of provisions) as of end-2022. Banks have continued focused on reducing NPLs while credit to the economy has largely come from Italian banks.

[1] Ex-BNS is the state-owned entity that deals with the liquidated BCIS (IMF Country Report No. 21/249).





14. Banks' capitalization and profitability were stable, but efficiency improvements have stalled. In 2022, the capital adequacy ticked up to 14.6 percent, with some banks just above the minimum capital adequacy, and profits remained positive but low (ROA 0.3 percent) for a second year. Profits are low considering that valuation losses from higher interest rates were only partially reflected (see below). Interest margins increased but expenditure reduction has stalled (noninterest expenses increased 3 percent). Thus, the cost structure of three of the four banks remains very high.

15. Banks' fixed income portfolio suffered losses due to higher interest rates, however the impact of higher interest rates on the quality of the loan portfolio has not been significant. In 2022, the unrealized valuation losses reached about 1.9 percent of total assets (€80 million). The losses were largely linked to securities with maturities below 2 years. To smooth the impact of the valuation losses, the authorities allow banks to transfer securities from the trading to the investment, held-to-maturity portfolio. Despite the negative valuation impact, higher ECB policy rates increased interest margins and banks' structural profitability going forward. The quality of banks' loan portfolio (most loans are at variable rates) has not been affected by higher interest rates because of the strong economic performance and a tight labor market.

Key Ratio of Sammarinese Banking System
(Percent unless stated otherwise)

	System
Solvency Ratio	14.6
Non-interest Bearing Assets/ Total Assets	20.5
NPL ratio	
Gross	53.1
Net of Provision	26.5
Cost-Income ratio	77.7

Source: Banks balance sheets; and IMF staff estimates.

OUTLOOK AND RISKS

16. In the context of weakened real income, tightening financial conditions and high global uncertainty, growth is expected to slow down towards its potential. The baseline projections assume no further escalation of the war, a slowdown in the Italian economy, higher for longer interest rates, and a gradual decline in commodity prices that remain above pre-war levels. Potential growth, at around 1.3 percent, reflects demographic factors as well as low productivity outside manufacturing.

- **Activity is forecasted to decelerate as temporary favorable conditions fade out.** Weakening external demand, the passthrough of higher input costs and higher financial costs will reduce firm's profitability from current high levels. Nevertheless, employment is forecasted to remain resilient with moderate wage growth, as firms are willing to retain skilled workers due to labor shortages. This will mitigate the adverse impact of inflation and higher interest rates on households' consumption.

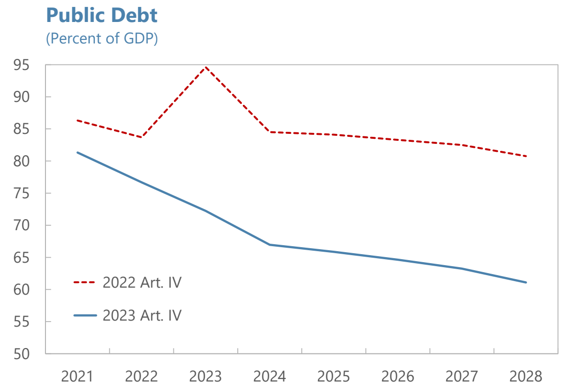
- **Inflation will remain elevated for longer.** Inflation is forecasted to peak in 2023 and then gradually decline following Italian trends. While wage growth will remain moderate this year and next, moderately elevated inflation is sustained by the passthrough of imported inputs.

Key Macroeconomic Indicators

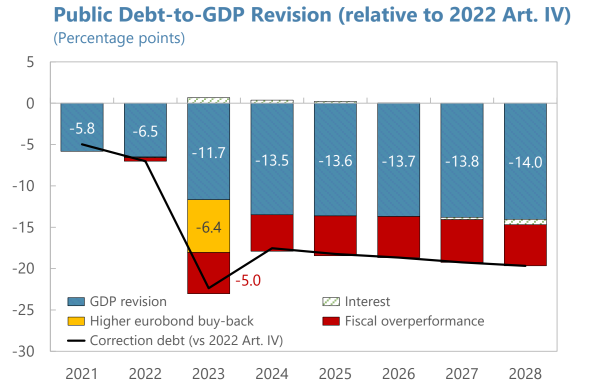
	2023A4					2022A4				
	2022	2023	2024	2025	2026	2022	2023	2024	2025	2026
					Percent					
Real GDP growth	5.0	2.2	1.3	1.3	1.3	3.5	0.2	1.0	1.3	1.3
Inflation - avg	5.3	5.9	2.5	2.0	2.0	6.9	4.5	1.5	1.7	1.9
Nominal GDP growth	7.9	8.4	4.8	3.2	3.3	7.2	5.3	2.7	2.6	2.7
Unemployment rate	4.3	4.0	3.9	3.9	3.9	5.4	5.7	5.0	5.1	5.1
					Percent of GDP					
Current account balance	8.0	3.8	2.9	2.1	1.4	1.3	0.7	0.9	1.0	1.1
Primary balance net of bank support	3.0	0.8	1.4	1.4	1.5	-1.2	-0.7	0.2	0.5	0.7
Consolidated Primary balance	1.2	0.0	0.9	1.1	1.1	-2.8	-1.6	-0.4	0.1	0.2
Public debt	76.7	72.2	67.0	65.9	64.6	83.7	94.6	84.5	84.1	83.3

Source: Sammarinese authorities, and IMF staff estimates.

17. **A strengthening fiscal position, relatively high inflation and economic growth have led to a sharp decline in public debt that is projected to further decline next year.** The primary balance net of bank support is projected to improve to 1.4 percent of GDP in 2024 driven by further expenditure consolidation—0.6 from moderate wage and pension indexation and lower transfers to the public utility company and 0.6 from lower capital spending after the one-off purchase of office space this year. High economic growth—particularly for 2021—, higher-than-expected deflators, and the larger-than-expected share of Eurobond bought-back explain the downwards revision of debt from 94.6 to 72.2 percent of GDP this year. Debt dynamics will remain supportive next year but, as inflation and growth moderate, the decline in public debt will decelerate. Overall, sovereign debt is assessed at moderate risk of debt distress. Nevertheless, it remains elevated for a microstate with limited fiscal buffers and significant ageing-related spending pressures.



Sources: Country authorities; and IMF staff estimates.



Sources: IMF staff estimates.

18. Risks are tilted to the downside:

- **External risks** are elevated and largely linked to the weakening of external economic conditions. An intensification of the war can weaken activity and create disruptions in energy supply. This combined with further monetary tightening can exacerbate weak external demand and higher production costs that would erode profitability. In this context, tax revenues can deteriorate and stress fiscal accounts. In turn, weak profitability and eroded households' income can increase loan impairment. In this scenario, fiscal policy should provide limited target support to vulnerable groups.

- **Domestic risks** relate to political risks given elections in 2024 that could weaken the fiscal position, and contingent liabilities from the financial sector (government guarantees to the Asset Management Company (AMC) and litigation from ex-BNS depositors). In this scenario, larger primary surpluses in the future may be needed to ensure sustainability.

19. On the upside, the economy can prove more resilient than expected supported by strong private sector balance sheets and a strong external position. A prompt approval of the association agreement with the EU would increase trade integration and potential growth. Paradoxically, further geopolitical fragmentation that implies a more rapid reconfiguration of trade and supply disruptions could increase external demand as EU firms accelerate nearshoring.

Authorities' Views

20. The authorities highlighted the resilience of the economy to shocks and stressed that prudent policies have increased buffers and supported activity. They see weakening external demand as the biggest risk but highlight the positive role that prudent collective wage agreements in the private and public sector have had to preserve employment and competitiveness.

POLICY DISCUSSIONS: STRENGTHENING THE FRAMEWORK TO COPE WITH SHOCKS

A. Fiscal Reforms to Strengthen the Fiscal Position Further

21. As San Marino is a euroized small open economy with a vulnerable financial sector and with limited fiscal buffers, an ambitious fiscal consolidation path remains critical. Without independent monetary policy and lack of a strong financial sector, fiscal policy is the main macroeconomic stabilization policy tool left. Importantly, euroization and limited domestic banks' liquidity call for strong public sector liquid buffers to support an effective emergency liquidity facility by the CBSM. As a small open economy, San Marino is vulnerable to external shocks that could result in a sharp decline in domestic demand and a weaker fiscal position. Furthermore, contingent liabilities linked to remaining legacies in the financial sector can stress fiscal accounts. With limited fiscal buffers, it is therefore key to maintain the recent fiscal consolidation path to place public debt in a decisively downward path. This will ensure ample government liquidity to face shocks and a more favorable access to international capital markets when needed.

Medium-term Fiscal Consolidation and Recommended Targets

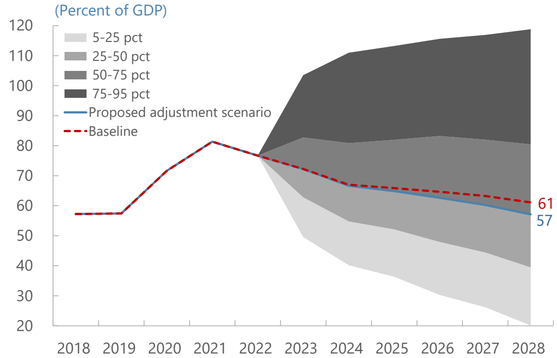
(Percent of GDP)

	Baseline				Proposed adjustment scenario		
	2023	2024	2026	2028	2024	2026	2028
CG: Primary balance net of bank support	**0.8**	**1.4**	**1.5**	**1.6**	**1.7**	**2.5**	**2.5**
CG: Primary balance net of transfers to pension fund [a]	3.0	3.6	3.6	3.6	3.9	4.6	4.6
Pension fund balance net of government transfers [b]*	-3.0	-2.7	-2.5	-2.9	-2.7	-2.5	-2.9
Consolidated primary balance [a]+[b]	**0.0**	**0.9**	**1.1**	**0.7**	**1.2**	**2.1**	**1.7**
Public Debt	72.2	67.0	64.6	61.1	66.6	62.6	57.1

* Proposed adjustment assumes no pension reform within the next 5 years.

San Marino: Public Debt

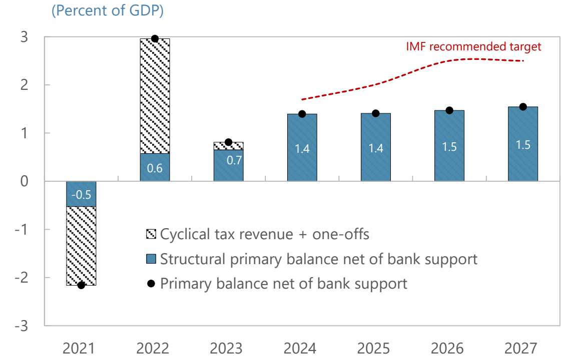
(Percent of GDP)



Sources: IMF staff estimates.

Primary Balance net of Bank Support

(Percent of GDP)



Sources: IMF staff estimates.

22. San Marino should target level of public debt below 60 percent of GDP. This goal is consistent with the current European framework and provides a simple, operational anchor that will build the necessary fiscal buffers and ensure sustainability. To achieve this goal by 2028, a moderate fiscal effort of 0.3 percent of GDP per year, for three years, in excess of the baseline path will be needed. This would require achieving a consolidated primary balance—central government plus the pension fund—of 2.1 percent of GDP (or a primary balance net of bank support of 2.5 percent of GDP) by 2026. To implement such fiscal consolidation the authorities can:

- **Mobilize revenue by improving the efficiency of the income tax and introducing a VAT.** There is significant room to broaden the income tax base by reducing allowances and incentives for businesses[2], but lack of political consensus will likely delay its approval until 2025 after the elections. The introduction of a VAT remains the key priority given its revenue and efficiency potential.[3] In addition, the authorities should consider expanding the use of excise duty to generate revenue and to address environmental externalities.

- **Improve the efficiency of public spending.** Enforcement of spending reviews across all public sector units as well as improved accounting, reporting, and transparency are needed to enhance control of public finances in the context of a comprehensive public financial management reform. Finally, better targeting of social programs through the adoption of income and wealth indicators could yield further savings without worsening social outcomes.

Structural Measures that Could Help to Achieve the Recommended Primary Balance
(Percent of GDP)

Tax increases	**1.7**
Reducing income tax rebates	1.0
VAT	0.6
Expanding excises	0.1
Spending cut	**0.7**
Cuts in subsidies and transfers to other government units	0.7
Total yield	**2.4**

Source: IMF staff estimates.

- **Continue prudent indexation of wages and pensions.** Recent indexation of public sector wages and pension below inflation will result in a structural consolidation if they are not compensated going forward. Thus, it is critical to avoid public sector wage and pension growth above inflation while inflation remains elevated.

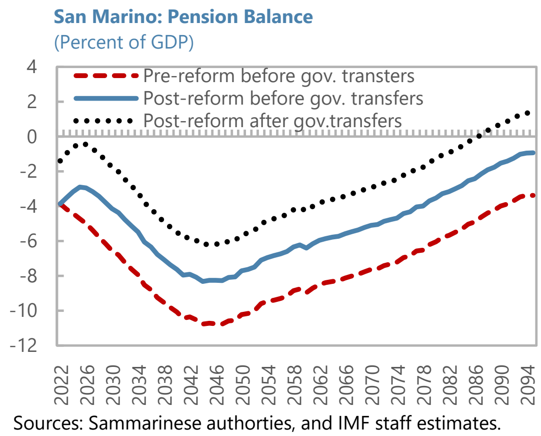
23. The pension reform provides fiscal relief over the medium-term, but long-term demographic challenges persist and will require a complementary parametric reform. The reform approved last year reduces the pension deficit and associated depletion of pension fund assets in the next decade by increasing contribution rates and marginally increasing the effective retirement age and the link between benefits and contributions.[4] However, the sustainability of the pension system post-2035 will require a complementary parametric reform focused on addressing the spending challenges due to aging, generous benefits, and low penalties for early retirement.[5]

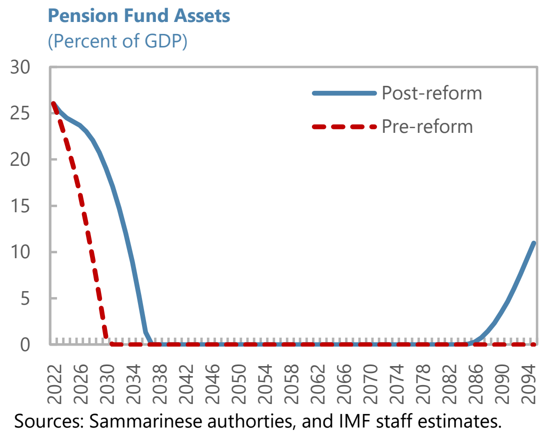
[2] See Annex V IMF Country Report No. 2021/249 and IMF Country Report No. 2022/349.

[3] See Box 3 IMF Country Report No. 2019/085.

[4] See IMF Country Report No. 2022/349.

[5] See IMF Country Report No. 19/85.





24. **The fiscal policy framework would benefit from a medium-term perspective that would increase its credibility and predictability.** This consists of medium-term fiscal projections, their impact on debt sustainability, and the quantitative assessment of proposed new policies. It should be complemented with a medium-term debt strategy (MTDS) that aims at maintaining healthy levels of liquidity while minimizing rollover risks and financing costs. In this connection, the authorities should consider smaller international issuances with longer maturities (5-7 years) and buy-back operations of the current Eurobond to smooth out GFN and reduce associated risks ahead of 2027. The MTDS should provide predictability and transparency on issuances to support the development of a domestic debt market, and ensure the government maintains deposits well above 2 months of spending (about 4 percent of GDP) to respond to shocks.

Authorities' Views

25. **The authorities highlight the significant improvement in the fiscal position since 2021 and agree that further efforts are needed to ensure sustainability.** They stress that the approved pension reform will contain deficits and postpone the depletion of the pension fund for a decade but agree that additional parametric adjustments will be needed in the medium-term. They are committed to strengthening the fiscal position further to accelerate the reduction of debt and consider that the introduction of the VAT will be inevitable in the context of further integration into the EU. The authorities underline the need to improve public financial management and spending efficiency including in extrabudgetary agencies. They agree that a medium-term fiscal strategy including through more predictable debt management will support transparency and predictability.

B. Reforms to Finalize the Banking System Reform

26. **San Marino banking system continues to face significant challenges.** Notwithstanding substantial consolidation and restructuring efforts since the GFC, the large share of non-income generating assets—NPLs and tax credits—, as well as high administrative costs still weigh heavily on profitability. At the same time, the high level of NPLs, low provisioning, uncertainty regarding the real value of collateral, and potentially low recovery values suggest that further losses are possible and would negatively affect the capital position of some banks. Thus, further measures are essential

to deliver a strong, viable banking system that supports growth. This will require reducing NPLs—with swift loss recognition if needed—increasing the income generating capacity and reducing operating costs in a system that remains oversized relative to the size of the economy.[6]

27. The authorities have made operational progress to establish an AMC and introduce calendar provisioning as part of their strategy to reduce NPLs (Annex VI). The arranger, servicers and rating agencies with international experience have been appointed. Their expertise in this area is welcome given the risks in determining the right transfer price of NPLs particularly if these are overpriced. Realistic recovery values are key for the credibility of the scheme, to avoid subsidies to banks' shareholders and to prevent fiscal risks. The authorities expect around €0.7 billion of gross NPLs will be transferred to the AMC, of which €0.2 billion will originate from ex-BNS assets. Once the valuation of NPLs is finalized, the senior tranches of AMC securities, guaranteed by the government, are expected to be placed in the market later this year. The mezzanine and junior tranches are expected to go back to banks' balance sheets at values equal to the difference between the net book value of NPLs and the value of the senior tranche. The risk weights for junior securities will be gradually adjusted to reflect the difference between the net book value and the real economic value of NPLs. The authorities see the introduction of calendar provisioning next year as an incentive for banks to participate in the securitization of NPLs and to address NPLs not transferred to the AMC. These measures should be implemented without further delay to force banks to recognize, even if just gradually, legacy losses and reduce forbearance.

28. A bold strategy to transparently reflect and strengthen banks' capital is needed given the likely loss recognition associated with NPL recovery in the context of AMC operations. The securitization will partly help provide a clearer view of potential capital needs that could originate at the time of the securitization of NPLs or when implementing calendar provisioning. Furthermore, public support to the financial system is already one of the largest and high public debt, equity and intergenerational considerations suggest that further support should be avoided. Thus, it is key to improve bank capital, avoid forbearance and limit fiscal risks:

- Profits should be retained to improve capitalization.
- Any potential capital needs, unlikely to be met with retained profits, should be addressed with credible capitalization plans. Delays to address capital needs should be met with strengthened use of supervisory measures.
- Legal limits on banks' shareholding structure should be promptly lifted.
- The bank resolution framework needs to be enhanced and aligned with European standards.
- To limit fiscal risks, the government guarantee should be based on realistic recovery values.

[6] IMF country report No. 21/149

- To boost the quality of Cassa de Risparmio of San Marino (CRSM)'s capital, the perpetual bond used to recapitalize it, should be converted into a marketable, liquid instrument. This process should be gradual and take into account its impact on public debt and debt service.

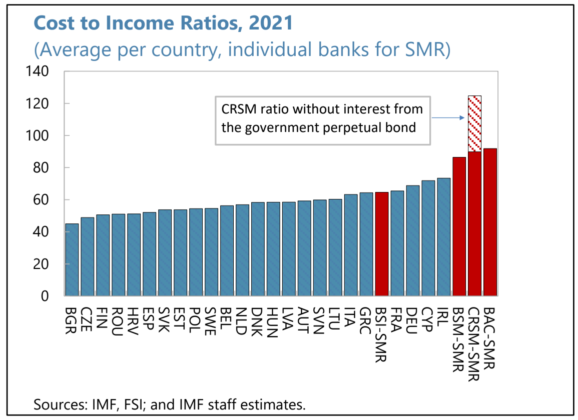
29. A strong governance structure including a realistic sunset clause for the AMC is crucial to limit political interference and reduce implementation risks. The operating cost structure, including managing and servicing fees and interest payments to senior bonds, should be carefully weighed against their benefits as higher operating costs would inevitably reduce final payouts to banks. A realistic sunset clause should be stipulated to incentivize a prompt liquidation of assets.

30. Finally, the revision of the insolvency and creditor rights framework is key to support NPL resolution and address structural issues. The securitization of NPLs depend on the proper functioning of the insolvency and debt enforcement regime. The authorities have taken important steps, particularly in the reform of auctions, introduced conditional sales as a new form of secured financing ("patto Marciano"), and simplified the procedures for small insolvencies. A more solid legal framework would increase the value of distressed loans and minimize losses. Also, the business environment would benefit from the modernization of corporate insolvency regimes and a more efficient debt resolution tools:

- The insolvency regime should be updated to include a wider range of restructuring tools to preserve the value of enterprises.
- The debt enforcement regime should prioritize the swift enforcement of mortgage loans.
- The insolvency and creditor rights framework should be strengthened with judicial resources, data collection mechanisms, and updated regime for insolvency representatives.

31. As high interest rates become persistent, the banking system faces new challenges:

- **Higher interest rates have enabled banks to increase net interest margins but, through their negative impact on activity, can also increase NPLs going forward**. With most credit at variable interest rates, higher rates add pressure on households at a time when high inflation is already eroding disposable income. So far households' income has been resilient supported by a strong labor market. Similarly, the strong balance sheet position and high profitability of companies has resulted in no deterioration of banks' loan portfolio so far. Banks should carefully monitor borrowers' repayment capacity and take proactive actions to prevent a deterioration in loan quality. Supervisors should ensure no misclassifications of loans.
- **No further losses in banks securities portfolio have occurred but new pressures can reemerge if monetary policy tightens for longer.** These risks in the trading portfolio need to be actively managed. While banks' reports disclosed the transfers of securities to hold-to-maturity investment portfolio in 2022 to ensure transparency, further losses in banks trading portfolio should be promptly recognized and absorbed by capital.



32. Given the small size of the economy and the access big corporates have to Italian banks, improving profitability is key to ensure financial sector viability. Despite two consecutive years of profits after 11 years of losses, banks' profitability remains significantly below euro area peers (already a low benchmark regarding banks profitability). In this connection, the lack of progress in reducing overinflated costs is disappointing. Banks should prioritize improving efficiency by reducing the oversized branch network, staffing levels and compensation, and increasing the share of income-generating assets.

33. The CBSM's financial position should be strengthened, including to enhance its lender of last resort (LOLR) capability. This is key to preserve its independence and financial sector stability. Additional financial resources will be needed to face compliance costs of adopting EU standards in the context of further integration. The reduction in reserves observed in the second half of 2022 due to higher interest rates has stabilized this year. Further reductions should be avoided so that the LOLR capacity of the CBSM is sufficient given the needs of a euroized economy. Thus, reserve requirements should be gradually increased from the current 3.5 percent to around 10 percent.[7] In addition, the new rules that allow diversification of pension fund assets abroad can cause a potential outflow of liquidity and commensurate reduction in reserves. Thus, this flexibility should be applied gradually taking into consideration its impact on system-wide liquidity.

34. San Marino should continue to make progress in strengthening implementation of the AML/CFT framework. The AML/CFT assessment report by MONEYVAL indicated substantial levels of effectiveness in many areas but identified remaining challenges in supervision, preventive measures, transparency of legal persons and legal arrangements, ML-investigations, and targeted financial sanctions for terrorism and proliferation financing. FIA continues to face the need to increase its resources to enhance supervision of (and thus compliance by) the financial and DNFBP sector. The authorities are finalizing the process of transposing the EU's 5th AML directive into the domestic legal framework and San Marino has demonstrated successful efforts in asset confiscation.

Authorities' Views

35. The authorities are confident that the securitization of NPLs and the introduction of calendar provisioning in line with the EU framework will be key to reduce NPLs. They highlighted the significant improvements in 2023 regarding capitalization (all banks met capital requirements), profitability, and the healthy level of liquidity. They acknowledge that the high level of NPLs remains the main challenge. However, they emphasized the full commitment of all parties to successfully complete the NPLs securitization and ensure that potential capital needs will be

[7] Annex VI in IMF Country Report No. 21/249.

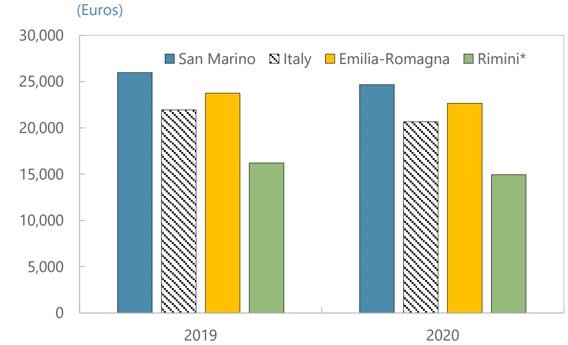
addressed proactively. This will be achieved, among other things, by removing legal limits on banks ownership structure. They emphasized the importance of strengthening the financial autonomy of CBSM in order to protect its effective supervisory action in the context of the adoption of the EU framework, including increased compliance costs.

C. Implement Structural Reforms to Support Private Sector-Led Growth

36. Structural reforms remain critical to increase the potential of the economy:

- **Labor Market**. A flexible labor market, including the liberalization of cross-border workers under the 2017 "Development Law" and measures introduced in 2021, have been key to absorb shocks while preserving employment and the competitiveness of the manufacturing sector.[8] Furthermore, going forward cross-border workers can also help to partly offset the negative impact of population ageing on the labor force supporting growth (Annex VII). Thus, further liberalization will alleviate the current tight labor market. In this connection, reforms were passed in 2022 to allow temporary contracts and to extend fixed-term contracts to a maximum length of 24 months. However, some restrictions need to be lifted to achieve the intended flexibility. In particular: restrictions on direct hiring of cross-border workers when unemployment is high; disincentives to fixed-term contracts that extend beyond the previous 18 months limit; and restrictions on the operation of temporary work agencies depending on the level of unemployment.

Annual Average Wage
(Euros)



*Nearest Italian city to San Marino.
Sources: Istat; San Marino Statistics Office; and IMF staff estimates.

- **Economic integration.** The association agreement would increase economic integration with the EU and expand market access by simplifying procedures and reducing legislative barriers. The authorities expect to conclude negotiations this year, but obstacles remain in the areas of the financial sector and labor market.

- **Ensuring sustainability of the energy sector:** Energy policy has served the country well, but the transition to the new tariff scheme has been erratic and experienced delays creating uncertainty. The new tariffs will ensure full pass-through but it may unnecessarily transfer excess volatility to final consumers. Thus, a new one-year fixed tariff, reflecting cost-recovery will be phased in to allow customers to choose between fixed and indexed tariffs. While the authorities plan to introduce a targeted social tariff for vulnerable groups,[9] consideration should be given to support vulnerable groups in a targeted manner strengthening the existing social safety net.

[8] See Annex IV about details of the 2017 "Development Law".

[9] Regulation states that AASS should submit a proposal for social tariffs by end-September (Decree 93/2023).

37. The authorities have timely published the data on their National Data Summary Page, following the IMF's Enhanced General Data Dissemination System (e-GDDS). The data provision remains broadly adequate for surveillance, though its frequency and quality need to continue improving. The authorities should consider updating the statistics law to facilitate data collection and strengthen the statistical autonomy of the office. Also, there is a need to continue improving national accounts by: rebasing real GDP and adopting a production-based GDP deflator. Finally, the authorities should consider transferring of the production of current account statistics to the CBSM.

Authorities' Views

38. The authorities emphasized the importance of labor market flexibility and economic integration with the EU to increase competitiveness. They are optimistic that the EU association agreement can be finalized this year and approved next. They stressed the importance of the labor market reforms approved last year and are committed to ensure that potential disincentives that may undermine the intended flexibility will be addressed. Finally, the authorities are committed to maintaining the capital strength of AASS, which is introducing new fixed price tariffs for energy in order to protect families from excessive price volatility.

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39. San Marino has shown remarkable resilience to covid, higher inflation and interest rates, and a weakening external demand. The rollover of the Eurobond reduced short-term risks. With the economy booming, employment reached record levels. However, with tightening financial condition, weak external demand, and heightened uncertainty, activity is expected to slow down.

40. The fiscal position has improved, and the risk of sovereign debt stress is moderate, but further efforts are needed to target a level of public debt below 60 percent of GDP. To achieve this target by 2028, a moderate cumulative fiscal effort of about 1 percent of GDP over the next three years is needed. This can be achieved through income tax reform, the introduction of a value added tax and/or expanding excise duties. Continuing prudent wage and pension indexation below inflation while inflation remains elevated will complement these efforts.

41. The recently approved pension reform will stabilize the pension system deficit over the medium-term, but long-term challenges persist that will require a parametric reform. With negative demographic trends, a complementary reform will be needed over the next ten years to address generous benefits, and low penalties for early retirement.

42. To strengthen the fiscal policy framework and ensure predictability, there is a need to develop and communicate a medium-term fiscal strategy. This strategy should provide a medium-term perspective of fiscal policy and be complemented with a medium-term debt strategy including liability management operations to smooth the large amortizations in 2027.

43. Banks' profitability has improved supported by higher interest margins, but higher interest rates also bring risks. With high nonperforming loans, high operational costs and weak capitalization in some banks just above the regulatory requirements, the financial sector remains vulnerable. However, a robust labor market has prevented the deterioration of the quality of the lending portfolio characterized by mostly variable-rate loans.

44. Further efforts are needed to improve banks' profitability and capitalization. Looking ahead, with increasing deposit rates, interest margins will decrease and impact profitability. Also, weaker economic activity can deteriorate loan quality. Thus, banks should use profits this year to increase capital, increase income-generating capacity, and restart efforts to reduce high operational costs that have recently stalled. Finally, CRSM's capital should be enhanced by gradually converting the perpetual bond into a liquid marketable instrument.

45. There has been operational progress in implementing the authorities' strategy to reduce NPLs through an Asset Management Company (AMC) and calendar provisioning. The appointment of reputable international firms with expertise for the securitization is welcome. The international placement of the senior tranche will provide liquidity to banks that could support future profitability. Introducing a realistic sunset clause for the AMC will be important to reduce implementation risks. NPLs remaining on banks books will be subject to calendar provisioning. Any undercapitalization that could arise from the securitization process and calendar provisioning should be promptly addressed with credible capitalization plans. Finally, the intention to establish the government guarantee below expected recovery values is welcome as it minimizes fiscal risks.

46. The bank resolution framework needs to be enhanced and aligned with European standards. The reform of 2019 failed to fully conform to the European framework. In addition, limits on banks' shareholding structure should be promptly lifted.

47. The CBSM financial position should be strengthened to safeguard its independence and support financial sector stability through an effective lender of last resort capacity. In this context, reserve requirements ratios should be gradually increased. Furthermore, adopting the European financial sector framework in connection with the EU Association Agreement will impose significant compliance costs on the CBSM that will have to be addressed.

48. San Marino should continue to make progress to strengthen its AML/CFT framework. The process of transposing the EU's 5th AML directive into the domestic legal framework is close to finalization which is welcome. The authorities should continue to tackle challenges identified in the 2021-MONEYVAL report, including by assessing ML-risks from the misuse of legal persons and legal arrangements. San Marino has demonstrated successful efforts in cases of asset confiscation. Finally, the authorities should ensure that the FIA has adequate resource to achieve its mandate.

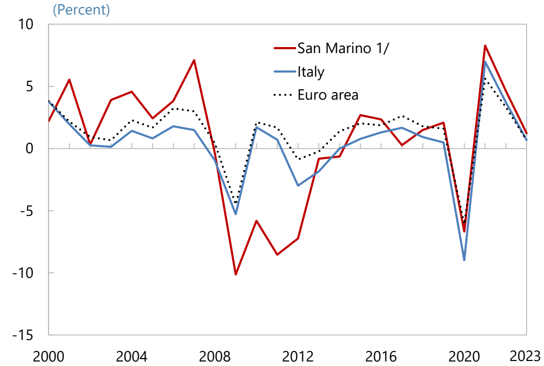
49. Structural reforms are critical to support the competitiveness of the manufacturing sector and consolidate recent gains in tourism boosting the growth potential of San Marino. The Association Agreement with the EU will enhance economic integration and attract foreign investments by reducing transaction costs. Recent labor market reforms regarding cross-border workers, temporary and fixed-term contracts aim at increasing flexibility. However, some provisions in the law could impede its effective implementation and may need to be amended. The authorities should continue to preserve the financial soundness of the state-owned utility company by ensuring tariffs reflect market and operational costs. Finally, increasing the efficiency of the insolvency and creditor rights framework will help address structural bottlenecks, increase investment and support NPL resolution. Lifting real estate restrictions on foreign ownership will also support this process.

50. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Figure 2. San Marino: Macroeconomic Developments

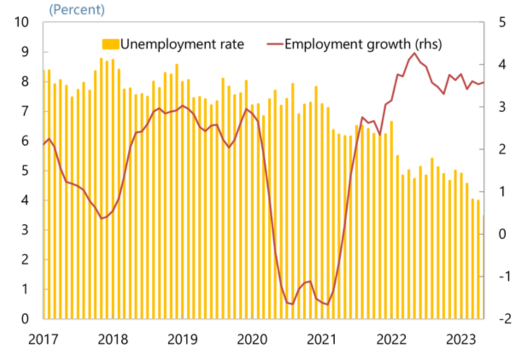
Real GDP growth was strong in 2022, with…

Real GDP Growth
(Percent)



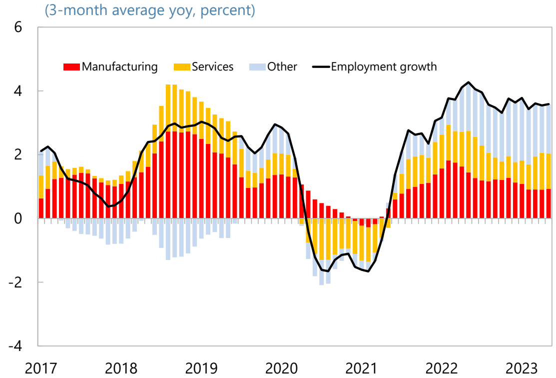
robust employment growth and low unemployment rate.

Unemployment Rate and Employment Growth
(Percent)



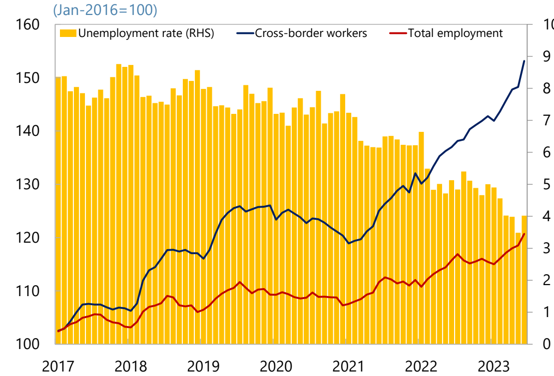
There was employment growth across sector, but especially in services and other sectors…

Sectoral Contributions to Employment Growth
(3-month average yoy, percent)



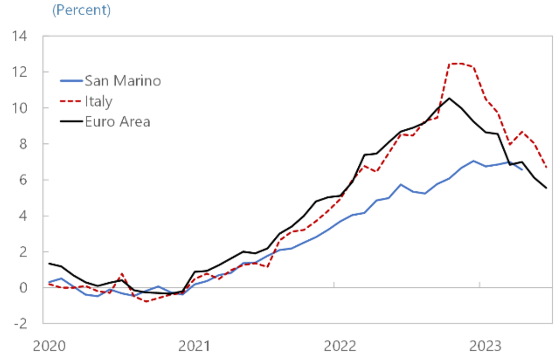
and hiring of cross-border workers continued increasing.

Employment and Cross-border Workers
(Jan-2016=100)



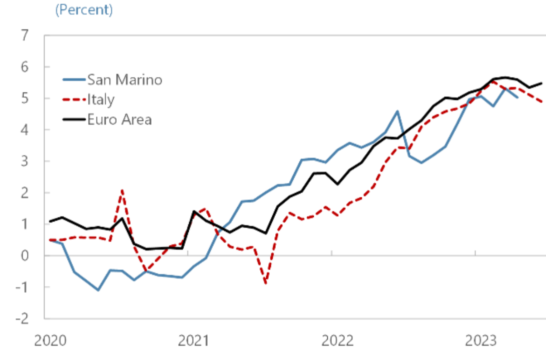
Headline inflation shows signs of abating…

Headline CPI Inflation
(Percent)



…but core inflation is still persistently high.

Core Inflation
(Percent)

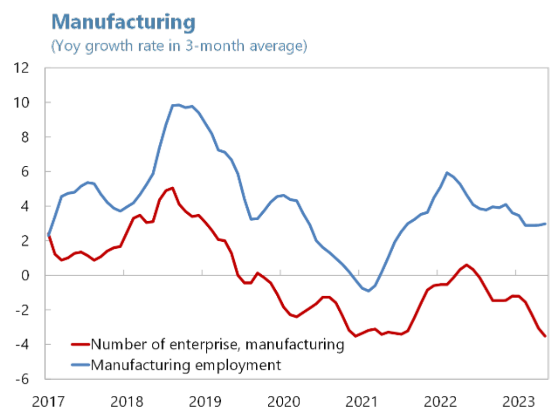


1/ Projections for 2021 and 2022.

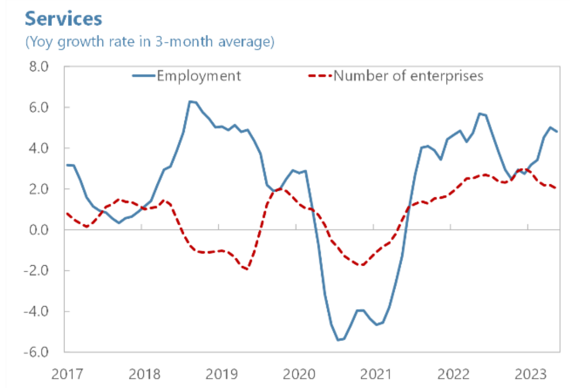
Sources: World Economic Outlook, Sammarinese authorities, and IMF staff.

Figure 3. San Marino: High Frequency Indicators

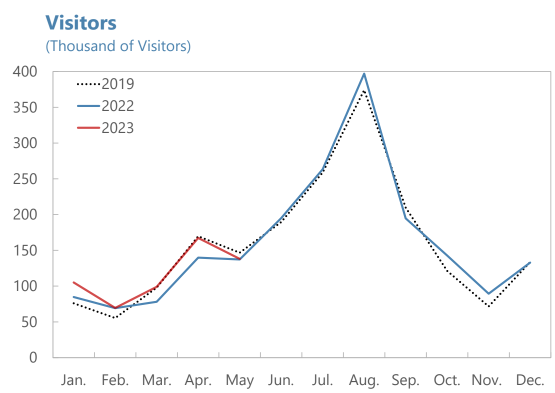
Manufacturing activity has remained strong….



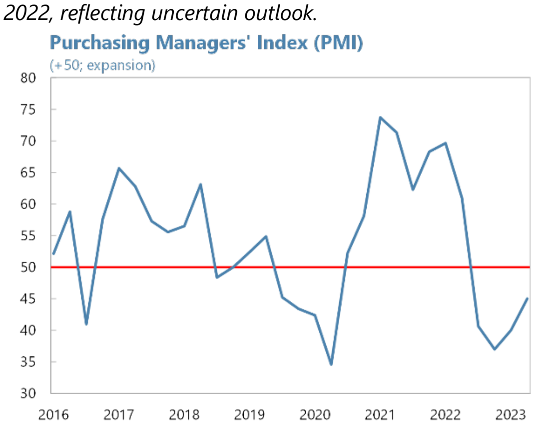
…while service sector employment growth is picking up.



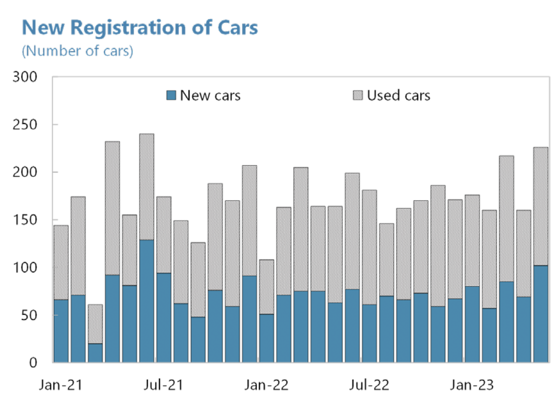
Meanwhile, tourism is back up to pre-covid levels…



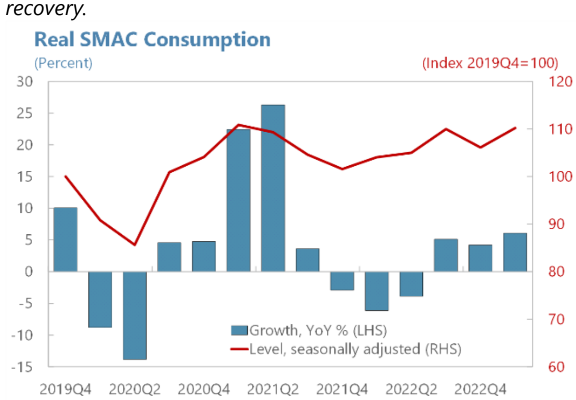
…while the PMI declined significantly in the second half of 2022, reflecting uncertain outlook.



New registration of cars grew in the first half of 2023



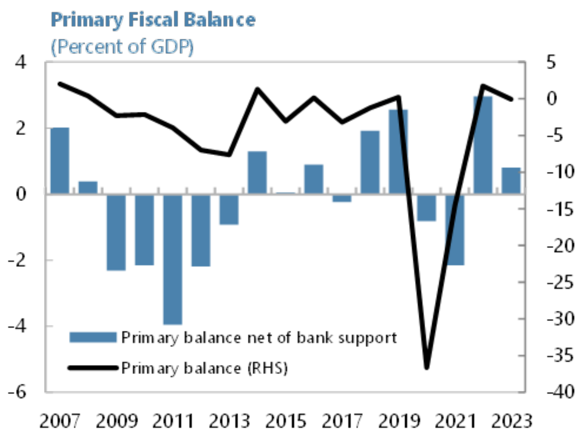
…and household nondurable consumption shows small recovery.



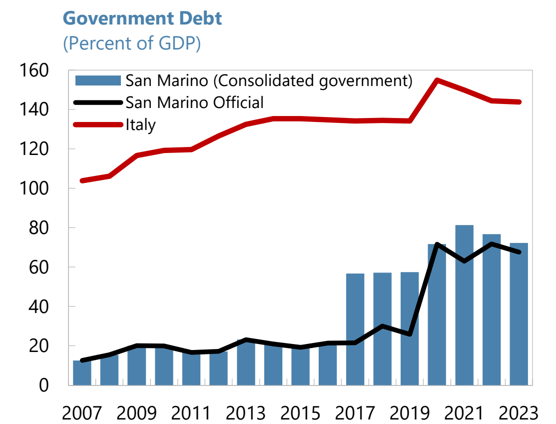
Sources: Sammarinese authorities and IMF staff.

Figure 4. San Marino: Fiscal Developments

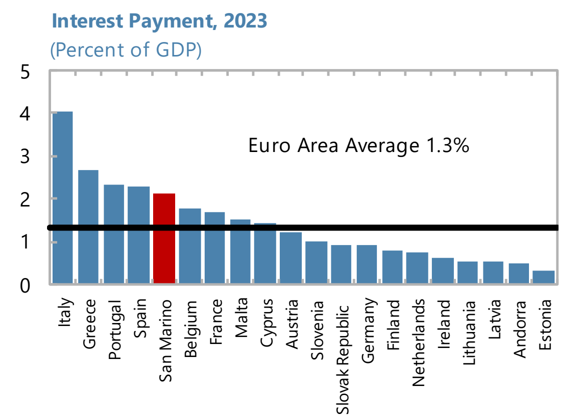
There has been progress towards a primary balance…



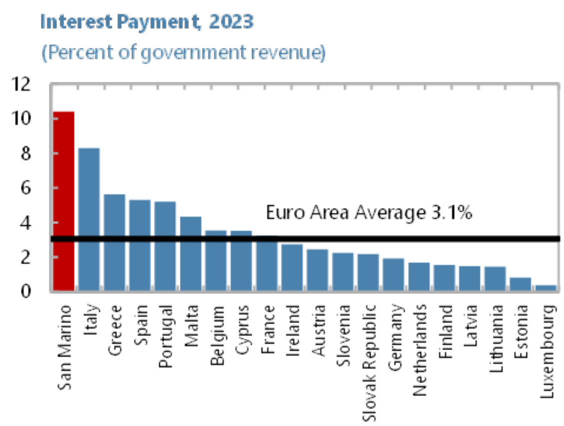
…but indebtedness remains high….



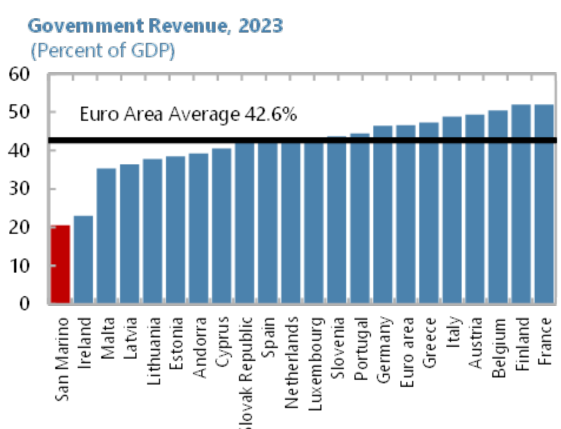
…leading to higher interest payments…



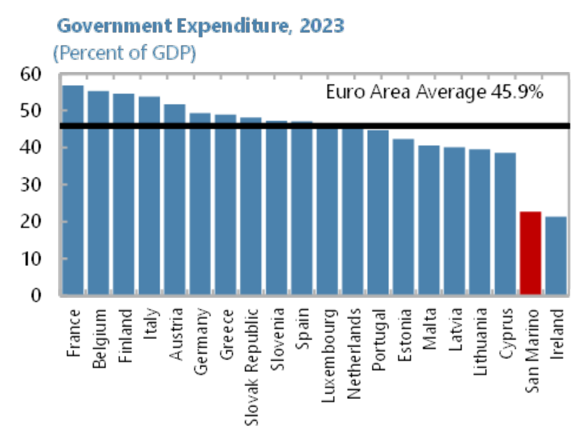
…especially in relation to government revenues….



…which are low by international standards…



….as is the overall size of the government.



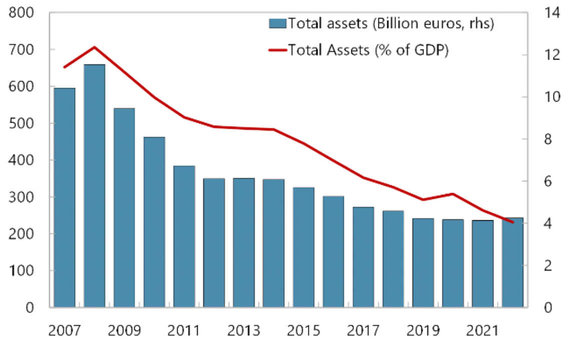
Sources: Sammarinese authorities, World Economic Outlook.

Figure 5. San Marino: Monetary and Banking Developments

Banking system assets have stabilized......

Banking System Assets

(Percent of GDP) (Billion euros)

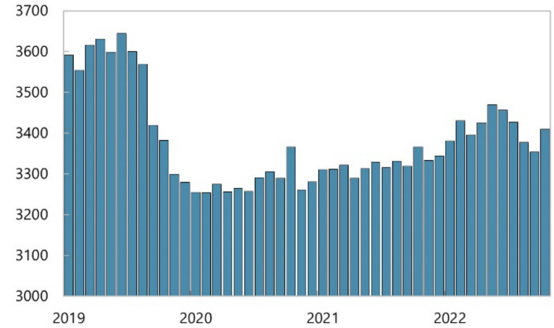


Note: As of June 2021. Includes assets from ex-BNS.

...with deposits recovering since the first Eurobond issuance improved system liquidity.

Total Deposits 1/

(Millions of euros)

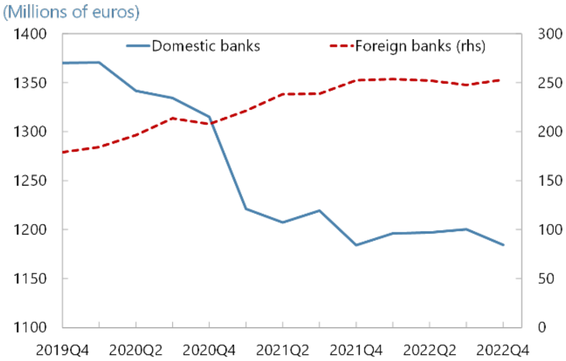


1/ Includes demand deposits, term deposits, and certificates of deposit.

Banks credit remains subdued despite strong growth...

Bank Credit to Private Sector

(Millions of euros)

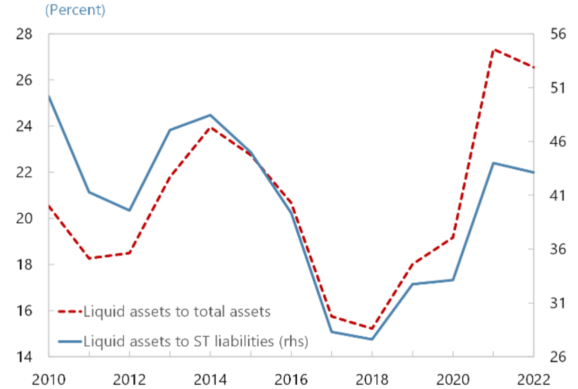


Sources: BIS and country authorities

...with liquidity recovering.

Banking Sector Liquidity

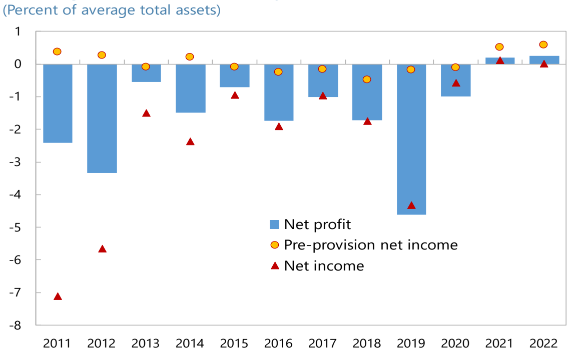
(Percent)



Profitability has continued...

Banking Sector's Profitability

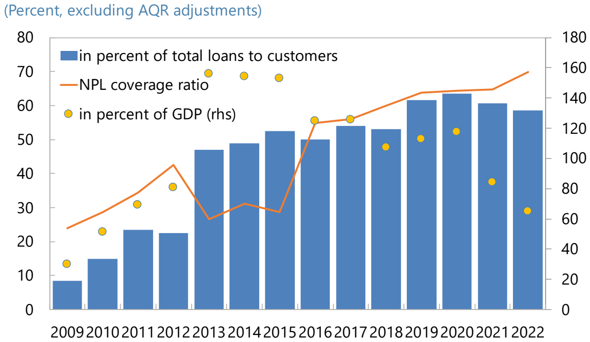
(Percent of average total assets)



...but NPLs remain extraordinarily high.

Banking Sector's Non-Performing Loans

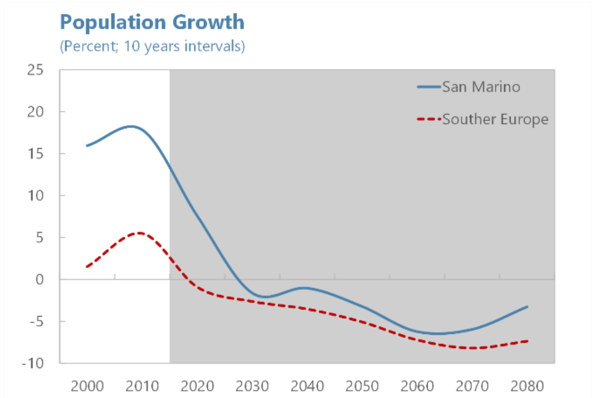
(Percent, excluding AQR adjustments)



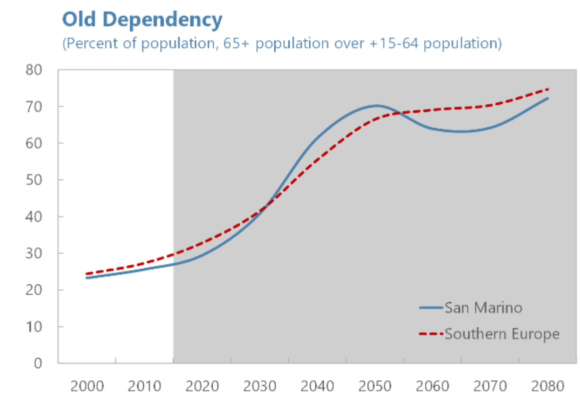
Sources: Sammarinese authorities and IMF staff.

Figure 6. San Marino: Demographics and Migration Trends

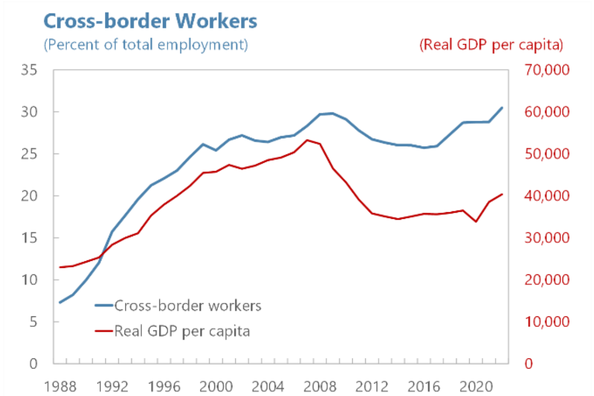
Population growth is expected to slowdown…



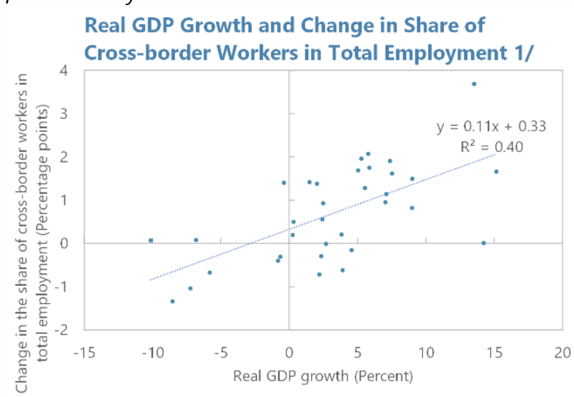
…and aging is forecasted to accelerate



Cross border workers played a key role in the labor force…

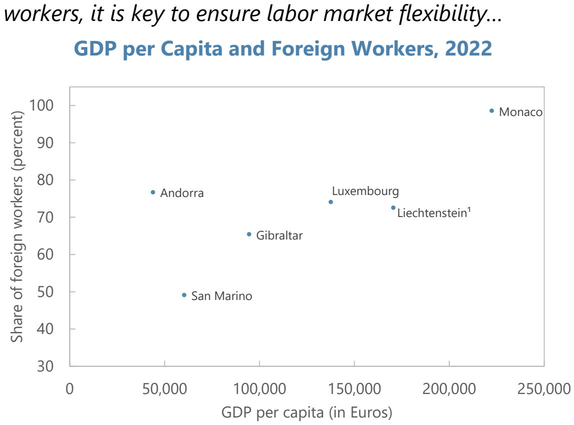


…in particular since foreign cross border worker demand follows the cycle.



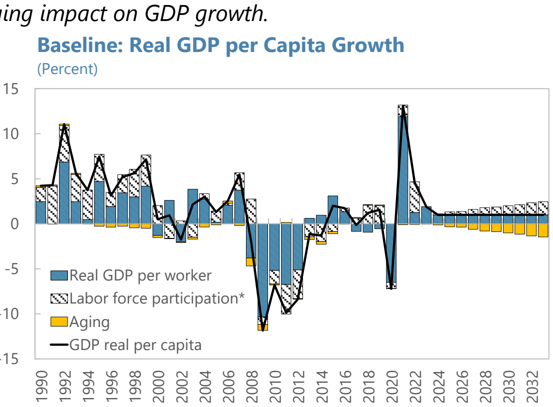
1/ Annual data covering 1989-2022.

As microstates tend to depend on a large share of foreign workers, it is key to ensure labor market flexibility…



1/ For Liechestein corresponds to 2021.

…cross-border workers can also help partly mitigate the aging impact on GDP growth.



* largely driven by cross-border workers growth

Sources: Sammarinese authorities; UN population Prospects 2022; and IMF staff.

Table 1. San Marino: Selected Economic and Social Indicators, 2019–28

GDP per capita (2021): 54,733 U.S. dollars | Life expectancy at birth (2018): 86.6 years

Population (2021): 33,921 persons | Literacy, adult (2015): 96 percent

				Est.	Projection					
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Activity and Prices										
Real GDP (percent change)	2.0	-6.8	14.2	5.0	2.2	1.3	1.3	1.3	1.3	1.3
Domestic demand	6.1	-10.5	5.8	1.7	4.4	1.8	1.1	1.1	1.1	1.1
Final consumption	1.4	-2.8	5.1	1.9	1.0	1.0	1.0	1.0	1.0	1.0
Fixed investment	17.8	-25.0	9.5	4.0	3.5	3.5	3.0	3.0	3.0	3.0
Net exports	-2.6	1.5	9.9	3.8	-0.8	0.1	0.5	0.5	0.5	0.5
Exports	0.4	-7.5	28.3	19.4	1.8	1.7	1.8	1.7	1.8	1.8
Imports	2.3	-9.6	26.2	20.7	2.5	2.0	1.8	1.8	1.7	1.8
Contribution to GDP	2.0	-6.8	14.2	5.0	2.2	1.3	1.3	1.3	1.3	1.3
Domestic demand	4.5	-7.5	4.7	1.7	1.1	1.1	1.1	1.1	1.1	1.1
Final consumption	0.8	-1.5	2.9	1.0	0.5	0.5	0.5	0.5	0.5	0.5
Fixed investment	3.7	-6.0	1.8	0.7	0.6	0.6	0.6	0.6	0.6	0.6
Inventories	0.2	-0.8	-0.4	-0.5	1.9	0.1	-0.3	-0.3	-0.3	-0.3
Net exports	-2.6	1.5	9.9	3.8	-0.8	0.1	0.5	0.5	0.5	0.5
Employment (percent change)	2.6	-0.5	2.0	1.9	0.7	0.8	0.7	0.7	0.3	0.3
Unemployment rate (average; percent)	7.7	7.3	5.2	4.3	4.0	3.9	3.9	3.9	3.9	3.9
Inflation rate (average; percent)	0.5	-0.1	2.1	5.3	5.9	2.5	2.0	2.0	2.0	2.0
GDP deflator (percent change)	0.9	0.5	1.5	2.8	6.1	3.5	1.9	1.9	2.0	2.0
Nominal GDP (percent change)	3.0	-6.3	16.0	7.9	8.4	4.8	3.2	3.3	3.3	3.3
Nominal GDP (millions of euros)	1,444	1,352	1,569	1,693	1,836	1,924	1,987	2,052	2,119	2,189
Public Finances (percent of GDP) 1/										
Revenues	22.3	21.6	20.7	22.7	20.5	19.7	19.7	19.7	19.7	19.7
Expenditure	22.4	59.2	37.1	22.3	22.7	21.3	21.1	21.0	20.8	20.0
Overall balance	-0.1	-37.6	-16.4	0.4	-2.2	-1.6	-1.4	-1.3	-1.1	-0.3
Primary balance net of bank support	2.6	-0.8	-2.2	3.0	0.8	1.4	1.4	1.5	1.5	1.6
Government debt (official)	25.9	71.6	63.0	71.7	67.6	62.6	61.6	60.5	59.3	57.3
Public debt 2/	57.4	71.6	81.3	76.7	72.2	67.0	65.9	64.6	63.2	61.1
Money and Credit										
Deposits (percent change)	-11.9	3.1	3.2	1.7	…	…	…	…	…	…
Private sector credit (percent change)	1.0	-4.1	-10.8	0.0	…	…	…	…	…	…
Net foreign assets (percent of GDP)	123.5	141.4	137.3	122.8	…	…	…	…	…	…
Commercial banks	96.1	94.4	87.4	91.7	…	…	…	…	…	…
Central bank	27.4	47.0	49.9	31.1	…	…	…	…	…	…
External Accounts (percent of GDP)										
Current Account	2.0	2.8	6.5	8.0	3.8	2.9	2.1	1.4	1.3	1.3
Exports	159.5	157.9	175.7	200.3	189.1	187.9	187.4	186.7	186.4	186.2
Imports	148.2	144.5	158.2	182.2	177.6	177.3	177.2	176.9	176.7	176.5
Gross int. reserves (millions of euros)	420.8	636.7	842.4	533.0	513.0	503.0	503.0	503.0	503.0	503.0
Gross int. reserves net of pledge assets (millions of euros)	420.8	636.7	842.4	671.1	651.1	641.1	641.1	641.1	641.1	641.1
Financial Soundness Indicators (percent) 3/										
Regulatory capital to risk-weighted assets	9.5	10.7	14.4	14.6	…	…	…	…	…	…
NPL ratio 4/	58.9	61.1	59.0	53.1	…	…	…	…	…	…
NPL coverage ratio 4/	63.6	64.4	65.0	69.8	…	…	…	…	…	…
Return on equity (ROE)	-74.6	-7.7	3.8	3.8	…	…	…	…	…	…
Liquid assets to total assets	18.0	19.2	27.3	26.5	…	…	…	…	…	…
Liquid assets to short-term liabilities	32.7	33.1	44.0	43.1	…	…	…	…	…	…

Sources: International Financial Statistics; IMF Financial Soundness Indicators; Sammarinese authorities; World Bank; and IMF staff.

1/ For the central government.

2/ Central government (official) debt plus Social Security Fund and BNS debt.

3/ 2017-19 data do not reflect 2017 AQR results.

4/ CBSM supervisory data. Latest data reflect changes related to Banca CIS resolution. Supervisory data, as opposed to FSI data, reflect retrospective revisions made by banks in their annual financial statements. Loans and NPLs to banks are excluded in calculating each indicator.

Table 2a. San Marino: Statement of Operations for Budgetary Central Government, 2019–28

(Millions of euros)

				Est.	Proj.					
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Revenue	322.5	291.9	324.3	384.2	376.9	379.5	391.0	403.8	417.1	430.8
Taxes	232.8	195.8	251.2	295.1	300.4	305.4	314.4	324.7	335.4	346.5
Income Taxes	131.8	119.4	141.8	162.6	161.5	162.3	167.6	173.0	178.7	184.6
Non-income taxes	100.9	76.4	109.4	132.5	138.9	143.1	146.9	151.7	156.7	161.8
Taxes on international trade and transactions	61.9	40.8	68.7	82.1	87.3	89.0	91.1	94.0	97.1	100.3
Other taxes	39.1	35.5	40.7	50.4	51.6	54.0	55.8	57.6	59.5	61.5
Non-tax revenue	89.8	96.2	73.1	89.1	76.5	74.2	76.6	79.1	81.7	84.4
Expenditure	324.1	800.3	581.8	376.8	417.0	410.5	419.6	430.0	440.5	437.5
Current Expenditure	304.0	795.9	580.1	371.0	401.1	406.7	415.6	425.8	436.1	432.9
Compensation of employees	91.5	85.6	90.4	92.6	98.3	100.7	103.9	105.6	107.2	110.8
Use of goods and services	23.2	21.3	23.6	25.0	32.1	33.6	34.7	35.9	37.0	38.3
Interest	5.0	12.9	29.9	22.5	39.2	42.2	41.1	41.2	41.2	39.2
Transfers	181.0	672.9	432.2	225.3	224.5	222.8	228.3	235.2	242.5	236.2
To other general government units	127.7	164.9	205.9	182.5	179.1	179.7	185.1	190.6	196.4	202.4
Bank Support	33.5	484.5	193.7	20.3	15.8	15.7	15.5	15.2	14.9	1.7
To other private sector entities	19.8	23.5	32.6	22.5	29.6	27.4	27.7	29.4	31.1	32.1
Other expenses (including subsidies)	3.3	3.2	3.9	5.7	7.1	7.4	7.6	7.9	8.2	8.4
Net acquisition of nonfinancial assets	20.1	4.4	1.7	5.8	15.9	3.8	4.0	4.2	4.4	4.6
Overall Balance	-1.6	-508.4	-257.6	7.4	-40.2	-31.0	-28.6	-26.2	-23.4	-6.6
Memorandum items										
Primary balance	3.4	-495.5	-227.6	29.8	-1.0	11.2	12.5	15.0	17.8	32.6
Primary balance net of bank support	**36.9**	**-11.0**	**-33.9**	**50.1**	**14.9**	**26.9**	**28.0**	**30.2**	**32.7**	**34.3**
Primary balance net of transfer to the pension fund [a]	42.1	-445.6	-172.6	81.0	55.1	68.4	70.4	73.4	76.8	79.3
Pension fund balance net of government transfers [b]	-49.4	-69.9	-74.1	-60.6	-55.5	-51.7	-48.9	-51.2	-56.5	-63.3
Consolidated primary Balance 1/	-7.3	-515.5	-246.7	20.3	-0.4	16.7	21.5	22.2	20.3	16.0
Consolidated primary balance net of bank support 2/	**36.9**	**-40.4**	**-62.5**	**31.2**	**-0.4**	**16.7**	**21.5**	**22.2**	**20.3**	**16.0**
Pension fund balance (incl. gov. transfers)	-10.7	-29.4	-28.6	-18.9	-15.3	-10.2	-6.5	-8.0	-12.4	-18.3
Public debt (official)	373.9	969.0	987.7	1,214.5	1,241.9	1,204.7	1,224.7	1,242.0	1,256.3	1,253.5
Public debt 3/	828.9	969.0	1,275.7	1,298.6	1,326.0	1,288.8	1,308.8	1,326.1	1,340.4	1,337.6
Nominal GDP	1,443.7	1,352.4	1,568.7	1,693.3	1,835.8	1,924.5	1,986.9	2,051.9	2,119.4	2,189.3

Sources: Sammarinese authorities; and IMF staff.

1/ Consolidated primary balance of the central government and the Pension Funds ([a]+[b]);

2/ Bank support from 2022 are transfers to the Pension Fund related to BCIS bailout.

3/ Central government (official) debt plus Social Security Fund and BNS debt.

Table 2b. San Marino: Statement of Operations for Budgetary Central Government, 2019–28

(Percent of GDP)

	2019	2020	2021	Est. 2022	Proj. 2023	2024	2025	2026	2027	2028
Revenue	22.3	21.6	20.7	22.7	20.5	19.7	19.7	19.7	19.7	19.7
Taxes	16.1	14.5	16.0	17.4	16.4	15.9	15.8	15.8	15.8	15.8
Income Taxes	9.1	8.8	9.0	9.6	8.8	8.4	8.4	8.4	8.4	8.4
Non-income taxes	7.0	5.6	7.0	7.8	7.6	7.4	7.4	7.4	7.4	7.4
Taxes on international trade and transactions	4.3	3.0	4.4	4.8	4.8	4.6	4.6	4.6	4.6	4.6
Other taxes	2.7	2.6	2.6	3.0	2.8	2.8	2.8	2.8	2.8	2.8
Non-tax revenue	6.2	7.1	4.7	5.3	4.2	3.9	3.9	3.9	3.9	3.9
Expenditure	22.4	59.2	37.1	22.3	22.7	21.3	21.1	21.0	20.8	20.0
Current Expenditure	21.1	58.8	37.0	21.9	21.8	21.1	20.9	20.7	20.6	19.8
Compensation of employees	6.3	6.3	5.8	5.5	5.4	5.2	5.2	5.1	5.1	5.1
Use of goods and services	1.6	1.6	1.5	1.5	1.7	1.7	1.7	1.7	1.7	1.7
Interest	0.3	1.0	1.9	1.3	2.1	2.2	2.1	2.0	1.9	1.8
Transfers	12.5	49.8	27.6	13.3	12.2	11.6	11.5	11.5	11.4	10.8
To other general government units	8.8	12.2	13.1	10.8	9.8	9.3	9.3	9.3	9.3	9.2
Bank Support	2.3	35.8	12.3	1.2	0.9	0.8	0.8	0.7	0.7	0.1
To other private sector entities	1.4	1.7	2.1	1.3	1.6	1.4	1.4	1.4	1.5	1.5
Other expenses (including subsidies)	0.2	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets	1.4	0.3	0.1	0.3	0.9	0.2	0.2	0.2	0.2	0.2
Overall Balance	-0.1	-37.6	-16.4	0.4	-2.2	-1.6	-1.4	-1.3	-1.1	-0.3
Memorandum items										
Primary balance	0.2	-36.6	-14.5	1.8	-0.1	0.6	0.6	0.7	0.8	1.5
Primary balance net of bank support	**2.6**	**-0.8**	**-2.2**	**3.0**	**0.8**	**1.4**	**1.4**	**1.5**	**1.5**	**1.6**
Primary balance net of transfer to the Pension Fund [a]	2.9	-32.9	-11.0	4.8	3.0	3.6	3.5	3.6	3.6	3.6
Pension fund balance net of government transfers [b]	-3.4	-5.2	-4.7	-3.6	-3.0	-2.7	-2.5	-2.5	-2.7	-2.9
Consolidated primary balance 1/	-0.5	-38.1	-15.7	1.2	0.0	0.9	1.1	1.1	1.0	0.7
Consolidated primary balance net of bank support 2/	**2.6**	**-3.0**	**-4.0**	**1.8**	**0.0**	**0.9**	**1.1**	**1.1**	**1.0**	**0.7**
Pension fund balance (incl. gov. transfers)	-0.7	-2.2	-1.8	-1.1	-0.8	-0.5	-0.3	-0.4	-0.6	-0.8
Public debt (official)	25.9	71.6	63.0	71.7	67.6	62.6	61.6	60.5	59.3	57.3
Public debt 3/	57.4	71.6	81.3	76.7	72.2	67.0	65.9	64.6	63.2	61.1
Nominal GDP (in millions of euros)	1,444	1,352	1,569	1,693	1,836	1,924	1,987	2,052	2,119	2,189

Sources: Sammarinese authorities; and IMF staff.

1/ Consolidated primary balance of the central government and the Pension Funds ([a]+[b]);

2/ Bank support from 2022 are transfers to the Pension Fund related to BCIS bailout.

3/ Central government (official) debt plus Social Security Fund and BNS debt.

Table 3. San Marino: Balance of Payments, 2019–28

(Percent of GDP, unless otherwise indicated)

			Est.	Est.	Proj.					
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Current account balance	2.0	2.8	6.5	8.0	3.8	2.9	2.1	1.4	1.3	1.3
Balance of goods and services	11.3	13.4	17.6	18.1	11.4	10.6	10.2	9.8	9.7	9.7
Goods balance	9.8	12.0	12.9	14.3	10.3	10.0	9.9	9.7	9.7	9.9
Exports	115.2	115.6	127.9	143.9	135.9	135.1	134.9	134.4	134.2	134.1
Imports	105.4	103.6	115.0	129.7	125.6	125.1	125.0	124.7	124.4	124.2
Services balance	1.5	1.4	4.7	3.8	1.1	0.6	0.3	0.0	-0.1	-0.1
Exports	44.3	42.3	47.8	56.3	53.1	52.8	52.5	52.3	52.2	52.1
Imports	42.8	40.9	43.2	52.5	52.0	52.1	52.2	52.3	52.3	52.3
Income balance	-8.5	-9.7	-10.2	-9.3	-7.0	-7.0	-7.3	-7.6	-7.6	-7.6
Credit	6.2	5.8	6.2	6.7	9.4	9.2	8.6	7.9	7.6	7.3
Debit	14.6	15.5	16.4	15.9	16.3	16.2	15.8	15.5	15.2	15.0
Secondary income balance	-0.8	-0.9	-0.9	-0.8	-0.7	-0.7	-0.7	-0.7	-0.8	-0.8
Capital account balance	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account balance	7.0	7.8	11.4	8.3	4.0	3.1	2.4	1.6	1.5	1.5
Direct investments	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Portfolio investments	-11.4	1.0	-1.5	1.8	-1.8	1.4	1.2	1.2	1.2	1.2
Other investments	7.1	-9.3	0.0	24.8	7.1	2.4	1.3	0.6	0.5	0.5
Change in reserve assets (increase = +)	11.3	16.1	12.9	-18.3	-1.1	-0.5	0.0	0.0	0.0	0.0
Net errors and omisions	-4.8	-4.8	-4.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items										
Nominal GDP (in millions of euros)	1,443.7	1,352.4	1,568.7	1,693.3	1,835.8	1,924.5	1,986.9	2,051.9	2,119.4	2,189.3
GIR (in millions of euros)	420.8	636.7	842.4	671.1	651.1	641.1	641.1	641.1	641.1	641.1
GIR net of pledged assets (in millions of euros)	420.8	636.7	842.4	533.0	513.0	503.0	503.0	503.0	503.0	503.0
GIR net of pledge assets (in months of imports)	2.4	3.9	4.1	2.1	1.9	1.8	1.7	1.7	1.6	1.6

Sources: San Marino Statistical Office and IMF staff.

Table 4. San Marino: Financial Soundness Indicators, 2016–22

	2016	2017	2018	2019	2020	2021	2022
Capital adequacy ratios (percent) 1/							
Regulatory capital to risk-weighted assets	11.5	13.7	12.3	9.5	10.7	14.4	14.6
Capital to assets	6.2	6.5	6.2	4.2	4.0	5.1	5.1
Asset quality ratios (percent) 1/							
Nonperforming loans to total loans	47.1	51.6	50.7	58.9	61.1	59.0	53.1
Nonperforming loans net of provision to capital	361.8	250.5	260.6	362.0	340.3	212.3	140.9
NPL coverage ratio	26.1	56.0	58.2	63.6	64.4	65.0	69.8
Earning and profitability (percent) 1/							
Return on assets (ROA)	-3.4	-0.7	-1.3	-4.3	-0.4	0.3	0.3
Return on equity (ROE)	-44.8	-10.3	-17.2	-74.6	-7.7	3.8	3.8
Interest margin to gross income	45.5	50.2	66.8	48.0	46.4	46.9	54.0
Non-interest expenses to gross income	105.3	108.4	141.2	137.7	98.7	68.9	63.7
Trading income to gross income	3.5	4.8	-23.1	3.8	-2.2	5.0	-4.1
Personnel expenses to non-interest expenditures	49.2	41.6	41.1	32.6	43.9	44.2	42.7
Liquidity (percent)							
Liquid assets to total assets	20.7	15.7	15.2	18.0	19.2	27.3	26.5
Liquid assets to short-term liabilities	39.3	28.3	27.6	32.7	33.1	44.0	43.1
Loans to deposits	153.8	141.4	125.6	124.1	108.4	71.3	63.7
Memo items							
Banking system assets (millions of euros)	5,328.8	4,795.3	4,616.6	4,213.1	4,191.1	4,143.7	4,252.3
percent of GDP	401.7	354.4	329.4	291.8	309.9	264.1	251.1

Sources: Sammarinese authorities; IMF International Financial Statistics; and IMF staff.

1/ 2017-18 data do not reflect 2017 AQR results, while 2019 data reflect changes related to Banca CIS resolution.

Table 5. San Marino: Depository Corporations Survey, 2016–22

(Millions of euros)

	2016	2017	2018	2019	2020	2021	2022
Net foreign assets	**2,134.4**	**1,865.5**	**1,749.7**	**1,782.6**	**1,912.7**	**2,153.8**	**2,079.6**
Claims on nonresidents	3,052.7	2,609.9	2,391.1	2,343.1	2,451.4	2,629.5	2,602.1
Central Bank	401.2	274.6	270.5	395.2	635.8	783.2	611.5
Other Depository Corporations	2,651.5	2,335.3	2,120.6	1,947.9	1,815.5	1,846.3	1,990.6
Liabilities to Nonresidents	-918.3	-744.4	-641.4	-560.5	-538.6	-475.7	-522.5
Central Bank	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-84.2
Other Depository Corporations	-918.2	-744.2	-641.2	-560.3	-538.4	-475.5	-438.3
Net domestic assets	**1,294.1**	**1,054.6**	**1,072.5**	**1,020.0**	**890.8**	**631.6**	**733.0**
Net Claims on Central Government	-119.5	-295.0	-304.8	-197.3	137.9	1.0	-9.3
Claims on State and Local Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on Public Nonfinancial Corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on NBFIs	381.2	263.0	242.6	119.0	111.7	84.8	63.8
Claims on private sector	1,468.5	1,481.0	1,381.7	1,394.8	1,338.2	1,193.2	1,193.0
Corporates	914.2	925.9	859.5	870.6	838.0	709.8	717.9
Households	554.3	555.1	522.2	524.2	500.2	483.5	475.1
Capital and Reserves	470.3	414.8	387.9	289.9	332.1	333.5	353.9
Other items, net	-34.3	-20.3	-140.9	6.6	365.0	313.9	160.5
Broad Money	**3,069.7**	**2,667.9**	**2,624.4**	**2,476.0**	**2,611.4**	**2,738.7**	**2,775.8**
Currency in Circulation	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transferable Deposits	1,371.9	1,364.2	1,415.3	1,447.4	1,617.4	1,811.6	1,916.7
Other Deposits	1,697.8	1,303.7	1,209.2	1,028.6	994.0	927.1	859.1
Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Deposits excluded from Broad Money	**0.7**	**0.7**	**0.7**	**48.1**	**6.3**	**0.7**	**0.7**
Securities and shares excluded from Broad Money	**358.1**	**245.4**	**189.8**	**273.3**	**185.8**	**46.1**	**26.0**
Loans	**0.0**	**6.2**	**7.3**	**5.3**	**0.0**	**0.0**	**10.0**
	(Percent)						
Growth rates							
Net foreign assets	**-8.7**	**-12.6**	**-6.2**	**1.9**	**7.3**	**12.6**	**-3.4**
Net domestic assets	**5.7**	**-18.5**	**1.7**	**-4.9**	**-12.7**	**-29.1**	**16.1**
Claims on private sector	-5.0	0.9	-6.7	1.0	-4.1	-10.8	0.0
Corporates	-3.3	1.3	-7.2	1.3	-3.8	-15.3	1.1
Households	-7.8	0.2	-5.9	0.4	-4.6	-3.4	-1.7
Broad Money	**-3.8**	**-13.1**	**-1.6**	**-5.7**	**5.5**	**4.9**	**1.4**

Sources: International Financial Statistics and IMF Staff.

Annex I. Risk Assessment Matrix[1]

Source of Risks	Impact if realized	Policy Response
External Risks		
High **Intensification of regional conflict(s).** Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, FDI and financial flows, and payment systems, and lead to refugee flows.	High Higher energy prices could significantly erode households' income and businesses' viability. Since 2023 tariffs are indexed to Italian wholesale energy prices to reduce fiscal risks, but this shifts risks to private sector.	• Prepare temporary programs for low-income households.
High **Abrupt slowdown or recession**. Intensifying fallout from the war in Ukraine, recurrent energy crisis and supply disruptions, and monetary tightening exacerbate economic downturns, and housing and commercial real estate market corrections.	Medium A recession on the Euro area could reduce San Marino exports significantly and therefore impact already vulnerable fiscal accounts.	• Enhance credibility by accelerating structural, fiscal, and financial sector reforms to reduce vulnerabilities and strengthen fiscal sustainability. • Provide limited and temporary support to mitigate the impact on vulnerable households and viable businesses.
Medium **Systemic financial instability.** Sharp swings in real interest rates and risk premia, and asset repricing amid economic slowdowns and policy shifts trigger insolvencies in countries with weak banks or non-bank financial institutions, causing market dislocations and adverse cross-border spillovers.	Medium The direct impact of a spike in yields and risk premia could increase the interest burden going forward, deteriorating the fiscal accounts. The indirect impact, due to weaker external demand, could reduce exports significantly and deteriorate fiscal accounts.	• Enhance credibility by accelerating structural, fiscal, and financial sector reforms to reduce vulnerabilities and strengthen fiscal sustainability. • Maintain high liquid buffers and explore options to obtain external contingent financing
Domestic Risks		
High **Slow fiscal consolidation and delays in implementing fiscal reforms** due to lack of political capital and social consensus around these reforms. Generous public wages and pensions indexation adding sizable fiscal cost.	High The lack of clear fiscal consolidation will increase vulnerabilities by increasing borrowing costs and limiting the government's ability to respond to shocks. It will also crowd out productive spending, thus undermining growth.	• Accelerate fiscal reforms, develop debt management capacity, and establish a Treasury department. • Diversify financing options; and seek technical support as needed.
Medium **Increase in government contingent liabilities** related to guarantees to be issued for NPL securitizations or bank support claims (e.g., ex-BNS bonds).	Medium High issuance of guarantees or the need to finance bank support could increase the sovereign spread and deteriorate the fiscal accounts.	• Avoid issuing guarantees for NPLs securitization beyond the expected recovery values. • Ensure enough legal resources to face court cases.
High **Slow banking system consolidation.** Limited progress in addressing potential recapitalization needs and cleaning up bank balance sheets. Slow improvement of profitability due to wage rigidity and greater competition from Italian banks.	High Insufficient implementation of measures to restructure the banking sector will lead to a deterioration of confidence, financial outflows, liquidity pressures in the banking system, and retrenchment of credit with adverse growth implications.	• Extend central bank power and tools for tackling failing banks. • Apply bank resolution tools and liquidity safeguards on an "as needed" basis. • Accelerate implementation of a financial sector strategy.

[1]The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

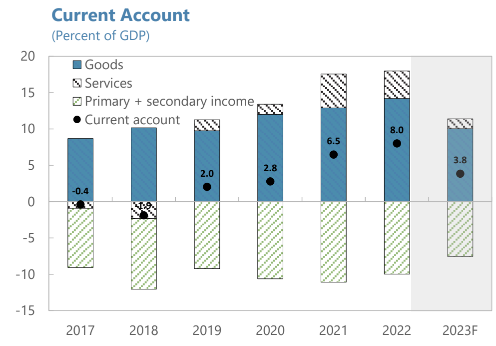
Annex II. Authorities' Response to Past IMF Recommendations

IMF Policy Advice from 2022 Consultation	Authorities' Action
Financial Sector Policy: • Increase reserve requirements • Time bound strategy for NPLs • Capitalization plans for banks and disclose losses due to banks' bond holding. • Continue improving banking system efficiency • Convert perpetual bond in CRSM to marketable domestic debt instruments • Set AMC following best international practices	• The central bank increased interest rates paid to reserves to stabilize reserve level. • Banks have increased capital. • Calendar provisioning is expected to start January 2024. AMC has made progress. The arrangers, servicers, and rating agencies for NPL securitization have been selected and valuation process is underway.
Fiscal Policy: • Rollover Eurobond and build up deposits • Pension reform to ensure sustainability • Fiscal adjustment over 3 years to 2.5% primary balance • Build debt management capacity	• The Eurobond was rolled over and government deposit remain above 2 months of spending. • Pension reform was approved. • The government followed a cautious indexation of wages and pensions and saved tax windfalls. • The debt office continues developing capacity and contacts with foreign and domestic investors.
Structural Reforms: • Liberalize the labor market • Deepen international integration • Improve the business environment	• Liberalization of frontier workers. • Partial amendments to the labor market law increased labor flexibility. • The government and the EU have speeded up the association agreement. • The agenda 2030 will include reforms to boost the business environment and address infrastructure needs

Annex III. External Sector Assessment

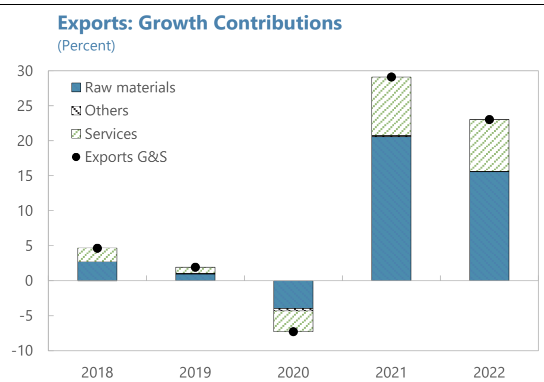
The external position of the Republic of San Marino in 2022 was broadly in line with fundamentals and desirable policies. Current Account (CA) and Real Effective Exchange (REER) gap models support this assessment. However, data weaknesses and a poor fit of models for San Marino call for caution.

1. **In 2022, the CA surplus expanded from 6.5 to 8 percent of GDP, driven by favorable external and domestic conditions:** (i) a robust recovery of the Italian economy, (ii) supply chain disruptions and higher transportation costs that temporarily affected Asian export-competitors, and (iii) the easing of covid restrictions that unlocked tourism. The CA increase was also supported by a moderate domestic wage growth that kept competitiveness and pre-covid investments that expanded manufacturing production capacity.

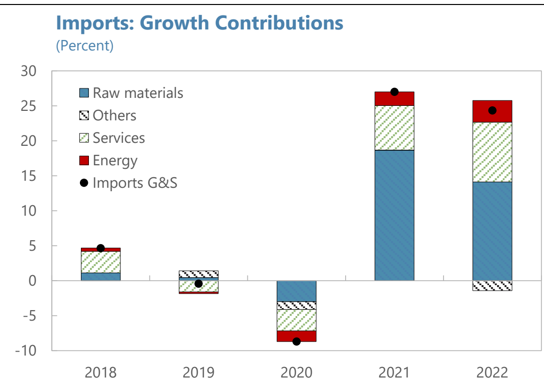


Sources: Country authorities; and IMF staff estimates.

2. **The improvement in the 2022 CA surplus was attributed to higher trade balance of goods and services.** Both exports and imports grew above 20 percent showing a robust expansion, in particular the manufacturing and tourism sectors. While supply disruptions in export-competitors allowed a favorable context for Sammarinese manufacturing companies, San Marino has used this opportunity to reposition their products and gain new markets beyond this temporary factors.



Sources: Sammarinese authorities; and IMF staff estimates.



Sources: Sammarinese authorities; and IMF staff estimates.

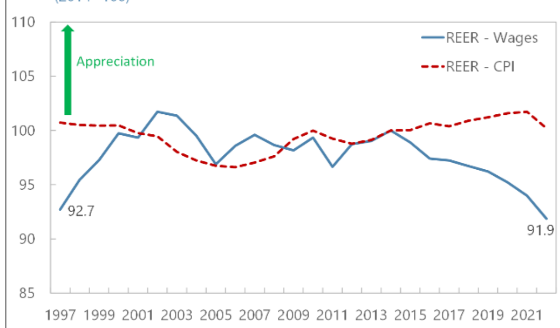
3. **The financial account outflows increased due the higher global interest rates.** Private deposits were reallocated abroad looking for higher yields. This process lowered gross reserves as banks withdrew part of their excess liquidity placed at the Central Bank of San Marino (CBSM). San Marino's gross international reserves (GIR) declined from €842 to €533 million between 2021 and 2022, reaching about 96 percent of the ARA metric.[1] The net international investment position (IIP)

[1] The team calculated an ARA metric that considers special features of the San Marino economy. The team-ARA is estimated at €553 million, close to the standard ARA methodology that implies an ARA of €556 million.

remained high, at 237 percent of GDP in 2022, but this figure may be overestimating the actual IIP since a large share of bank-loans to nonresidents are NPLs.

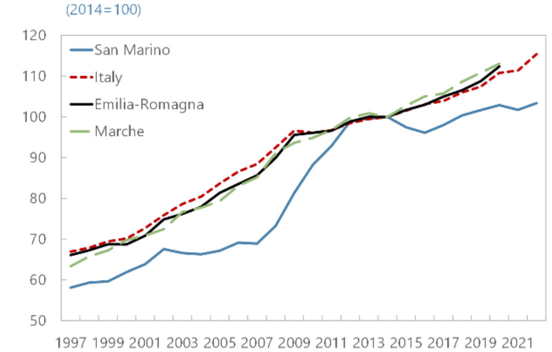
4. San Marino's export market share has been stable for almost a decade, but competitiveness is recovering (see Annex V). Up until 2013, the country lost about two-thirds of its world export market share compared to the pre-GFC period due to a significant adjustment of the financial sector (it permanently lost 80 percent of its value added over 2008-14) compounded by the inclusion of the country in the 'blacklist' of jurisdictions with preferential tax regimes by Italy from 2010 to 2014 as well as a weak post-GFC recovery in Italy. All this contributed to a significant reduction in export of goods over 2008-14. The loss in exports' market share occurred during a prolonged appreciation of the REER on account of a persistent, positive inflation and labor costs differential vis-à-vis Italy. However, the situation stabilized in 2014 when a sustained gradual recovery started largely driven by moderate wage growth that contained unit labor costs improving competitiveness. More recently, the REER improved as inflation in San Marino lagged inflation in Italy in 2022. While overall competitiveness has improved there are still structural gaps including on regulation for starting a business, enforcing contracts, resolving insolvency, protecting minority investors, and dealing with construction permits.

REER Relative to Italy
(2014=100)



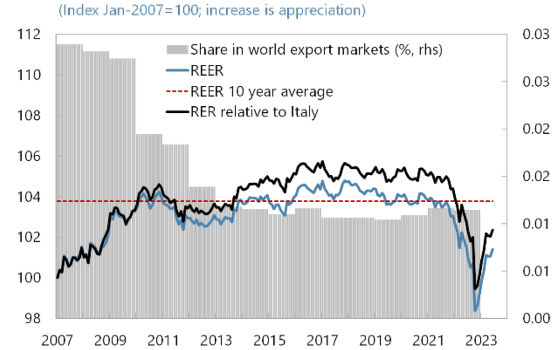
Sources: IMF staff estimates.

Unit Labor Cost - Wages
(2014=100)



Sources: Sanmarinese authorities, Italian authorities, and IMF staff estimates.

CPI-Based REER and Export Market Share
(Index Jan-2007=100; increase is appreciation)



Sources: Sammarinese authorties, Haver, IFS, and IMF staff.

5. Both the CA and REER index models indicate that the real exchange rate is in line with fundamentals and desirable policies, although the models' fit for San Marino is poor.

- **Current account approach (EBA-Lite):** The estimated 2022 CA norm and the implied CA gap stood at 9.5 and 0.9 percent of GDP, respectively. The high CA norm primarily reflects the relatively high net foreign asset position.[2] of the economy relative to its key trading partners. The model estimates of cyclical adjustment factors are small, and the policy gap is mostly driven by a stronger fiscal performance relative to its key trading partners. Overall CA estimates should be taken with caution given the model's poor fit for San Marino and data weaknesses, which limit the ability to assess the REER elasticity with high confidence. As in previous assessments (i) we followed the EBA-Lite tool guidance and re-estimated San Marino' fixed effect since it is no more included in the EBA-Lite sample; and (ii) re-estimated the elasticity to account for the high share of re-exports in manufacturing exports (manufacturing imports represent about 65 percent of manufacturing exports).

- **REER index model:** The REER gap is 1.6 percent, corresponding to a CA gap of -1.2 percent. This estimate differs from the previous Article IV consultation reflecting the depreciation recorded in REER during 2022.

Model Estimates for 2022
(In percent of GDP)

	CA model 1/	**REER model**
	(in percent of GDP)	
CA-Actual	**8.0**	
Cyclical contributions (from model) (-)	-0.5	
Natural disasters and conflicts (-)	-0.1	
Adjusted CA	**8.6**	
CA Norm (from model) 2/	**9.5**	
Adjusted CA Norm	**9.5**	
CA Gap	**-0.9**	**-1.3**
o/w Relative policy gap	0.0	
Elasticity	-0.8	
REER Gap (in percent)	**1.2**	**1.7**

1/ Based on the EBA-lite 3.0 methodology
2/ Cyclically adjusted, including multilateral consistency adjustments.

6. Staff assess San Marino's external position as broadly in line with fundamentals and desirable policy settings. Staff based its assessment on the CA and REER index models. Despite the external position is assessed as broadly in line with fundamentals, given the high uncertainty, San Marino needs to continue advancing in structural reforms to enhance the flexibility of the economy and maintain the external competitiveness and keep exports growth momentum.

[2] The stock of NIIP stood at 237 percent of GDP in 2022, of which 73 percent of GDP was related to banks and 132 percent attributable to other corporations, households, and Nonprofit Institutions Serving Households (NPISHs).

Annex IV. Sovereign Risk and Debt Sustainability Assessment[1]

Public debt is projected to drop to 72 percent of GDP at the end of 2023 and decline slowly over the medium-term due to the favorable impact of the economic recovery, higher medium-term GDP deflator inflation, and consolidation efforts. However, there are significant risks associated with uncertainty over future growth, the materialization of contingent liabilities arising from the financial sector, and large spikes in gross financing needs over the medium-term.

A. Background

1. San Marino's public debt has been in a decisively declining path for the last two years. After sizable bank support, public debt peaked in 2021 at 81 percent of GDP. Since then, debt has declined to 72 percent of GDP by end-2023. This large decline, 9.1 percent of GDP, was driven by an acceleration in nominal GDP in 2021-23—a cumulative nominal growth of 17 percent of GDP—which was combined with improvements in primary surpluses—4 percent of GDP over the same period—that nevertheless still contributed to increase debt due to the deficit of the pension system.

2. The coverage of the fiscal accounts for debt sustainability in San Marino consists of the consolidation of the central government, pension fund and former BNS.[2] As argued in previous staff reports,[3] official debt in San Marino has not traditionally recognized the full extent of fiscal liabilities toward the banking sector. Therefore, staff adopted a broader coverage of the public sector accounts: the consolidated government, which includes the consolidated debt of the budgetary government, the social security fund, and the former BNS. For this assessment, the deficit of the consolidated government is computed as the sum of the central government (net of transfers to the pension fund) and the balance of the pension funds (net of government transfers). Thus, pension fund deposits in the former Banca Credito Industriale Sammarinese (Banca CIS) are no longer included in the stock of public debt, but their repayment is part of the transfers from the central government to the pension fund.

3. Public debt-to-GDP has been revised down significantly relative to the 2022 Article IV as nominal GDP surprised on the upside in 2022 and was revised up in 2021. Public debt-to-GDP was estimated at 95 percent by end 2023 in the 2022 Article IV, in contrast to the current estimate of 72 percent. This difference is explained by i) a revision of the 2021 nominal GDP growth which increased from 9 to 16 percent (see Box 1); ii) a higher GDP deflator for 2023 (see table IV.1); iii) improved fiscal performance; and iv) a higher early repayment of the Eurobond maturing in 2024. While the latter was just a timing issue that affected only the short-term level of gross debt, the former factors have reduced debt permanently by around 18 percent of GDP. Despite these changes

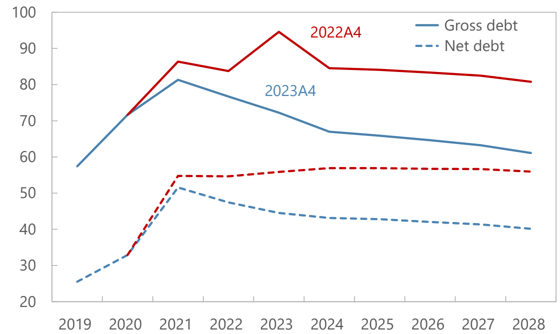
[1] Prepared by Ezequiel Cabezon.

[2] The government guarantees related to AMC operations is not considered public debt but included in the contingent liability shock below given it is planned to be conservatively set below expected recovery values.

[3] See Annex III in IMF Country Report No. 2021/249 and IMF Country Report No. 2022/349.

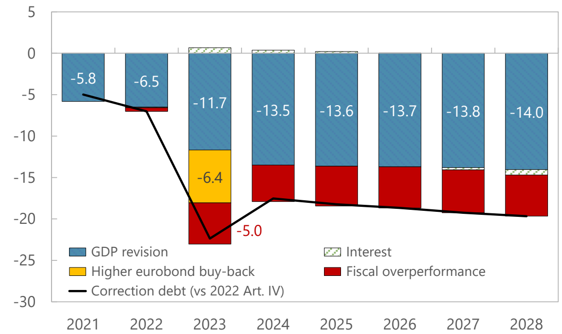
in the level of debt, the dynamics going forward are similar to those in the 2022 Article IV with the decline in debt marginally faster under current projections.

Public Debt
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.

Public Debt-to-GDP Revision (relative to 2022 Art. IV)
(Percent of GDP)



Sources: IMF staff estimates.

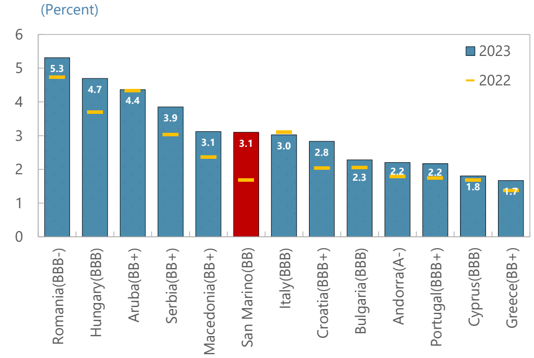
4. The authorities rolled over the Eurobond and continue developing the domestic debt market. In May 2023, the government issued a new Eurobond with a 6½ percent coupon and 3¾-year maturity. The issuance reached €350 million of which €287 million were tendered to investor holding the old Eurobond maturing in 2024. The net flows (€63 million) will be used mostly to repay the remaining principal maturing in February 2024 (€53 million). The authorities continued developing the domestic bond market by: i) rolling over €50 million of domestic short-term bonds in 2023; ii) converting the remaining €142 million of bonds from former BNS (maturing in 2024 and 2026) into government bonds with a 1.5 and 1.75 percent interest and a 15 and 20-year maturity respectively. Finally, the government repurchased €12 million of government bonds from ex-BNS bond holders.

Public Debt Structure

	2021	2022	2023	
	Million euros	Million euros	Million euros	Percent
External	**350**	**349**	**411**	**31.0**
External loans	10	9	8	0.6
Eurobonds	340	340	403	30.4
Domestic	**925**	**950**	**915**	**69.0**
Dom. loans	74	57	39	3.0
Dom. Bonds: Market	84	134	134	10.1
Dom. Bonds: Perpertual bonds	456	456	456	34.4
Dom. Bonds: BNS Converted	0	196	184	13.8
BNS-Bonds	204	0	0	0.0
BNS-others	84	84	84	6.3
Payable accounts	24	24	19	1.4
Total	**1,276**	**1,299**	**1,326**	**100.0**
of which nonmarket[1]	767	759	742	56.0

[1]Include payable accounts, perpetual bonds, BNS bonds, and BNS other liabilities.

Implicit Interest Rate of Government Debt, 2023
(Percent)



Sources: IMF staff estimates.

5. As a large part of public debt is irresponsive to interest rate volatility, the effective interest rates remain moderate notwithstanding higher interest on the new Eurobond. Only 5 percent of the debt is at variable interest rates at end-2023 and 56 percent of the debt is nonmarketable with low interest rates and long maturities.[4] This helps contain the impact of higher global interest rates on interest payments. However, the implicit interest rate increased by about 1

[4] Nonmarketable debt includes CRSM's perpetual bond with 1.75 percent coupon, bonds to convert former BNS bonds (with 1, 1.5, and 1.75 percent coupon and 10, 15, and 20 years maturity, and other accounts payable.

percentage point of which 0.8 percentage points were due to the new Eurobond and 0.2 percentage points were due to the conversion of former BNS bonds to longer maturities. Nevertheless, the overall interest rate on government debt is similar to countries with similar credit ratings.

B. Baseline

6. **Under the baseline, public debt is projected to decline over the medium-term.** Public debt is projected to be around 61 percent of GDP by 2028, but with social security deposits being drawn down at an increasingly faster pace given increasing projected pension fund deficits notwithstanding the positive impact of the reform approved last year. The pension funds' assets will decline from 24 to 19 percent of GDP by 2028 and could be fully depleted by 2037. In the baseline scenario the key assumptions are:

- Real GDP growth is projected at 2.2 percent in 2023, and then it stabilizes at potential, 1.3 percent, over the medium-term.
- The central government primary balance (under current policies) is projected to deteriorate this year, largely due to one-off operations related to the purchase of office space but improve thereafter as the indexation of public wages and pensions remain below inflation. As a result, the consolidated primary surplus peaks at 1 percent by 2025-26 and then gradually deteriorates as ageing accelerates pension spending.
- The implicit government interest rate on debt is higher than in previous assessment due to higher global interest rates, higher Eurobond coupon, and the conversion of Ex-BNS bonds.

Table IV.1. San Marino: Key SRDSF Assumption
(Percent)

	2021	2022	2023	2024	2025	2026	2027	2028
Real GDP Growth (percent)								
2023A4	14.2	5.0	2.2	1.3	1.3	1.3	1.3	1.3
2022A4	8.3	3.5	0.2	1.0	1.3	1.3	1.3	...
GDP deflator change (percent)								
2023A4	1.5	2.8	6.1	3.5	1.9	1.9	2.0	2.0
2022A4	0.9	3.5	2.2	1.6	1.8	1.9	1.9	...
Consolidated primary palance (percent of GDP)								
2023A4	-15.7	1.3	0.0	0.9	1.1	1.1	1.0	0.7
2022A4	-16.4	-2.8	-1.6	-0.4	0.1	0.2	0.1	...
CG: Primary balance net of transfers to pension fund								
2023A4	-11.0	4.8	3.0	3.6	3.5	3.6	3.6	3.6
2022A4	-11.7	1.3	1.8	2.7	3.0	3.1	3.2	...
Pension fund balance net of gov. transfers								
2023A4	-4.7	-3.5	-3.0	-2.7	-2.5	-2.5	-2.7	-2.9
2022A4	-4.7	-4.1	-3.4	-3.1	-2.8	-2.9	-3.1	...
Implicit interest rates (percent)								
2023A4	3.4	1.7	3.1	3.1	3.2	3.2	3.1	3.0
2022A4	3.4	1.9	1.9	2.0	2.7	2.7	2.7	...

Source: IMF staff estimates.

C. Risk Assessment

7. Public debt will slowly fall under the baseline from current moderate levels. As a euroized economy with limited policy buffers, San Marino remains vulnerable to shocks including external shocks to growth, the materialization of contingent liabilities arising from the financial sector, and spikes in medium term gross financing needs (GFN). As a result, risks remain significant.

8. Medium-term risks are assessed to be moderate. The GFN module points out to moderate risks in line with the low GFN for the next 4 years. However, the spike in GFN in 2027 as the Eurobond matures, 23 percent of GDP, will increase risks. The fanchart mechanical signal points out to high risk. Such signal is derived from the fanchart width that estimates the uncertainty of public debt based on historical shocks. For San Marino past shocks may not be a good indication of potential future shocks as past bank support overwhelmingly explains the increase in public debt historically. However, shocks of these magnitude are unlikely to take place going forward (see Box IV.1). Thus, staff is of the view that risks over the medium-term are moderate.

9. A medium-term worst-case scenario of contingent liability shock. This scenario envisages potential risks associated with further capital needs in the financial sector, calibrated to cost around 6 percent of GDP, public guarantees related to the securitization of NPLs, calibrated to cost about 7 percent of GDP, and tax credits (which could cost an additional 9 percent of GDP). In this scenario, public debt reaches 86 percent of GDP by 2024 but maintains a moderately declining path thereafter.

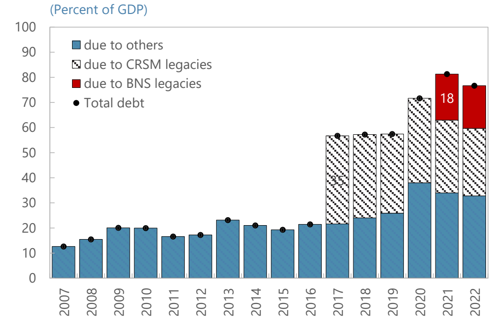
10. Long-term risks are assessed as moderate. Demographics are expected to accelerate pension spending in the long-term, however the recent pension reform has delayed the depletion of pension fund assets by, at least, a decade. This provides time to evaluate the impact of the recent reform and design the needed complementary (parametric) reform focused on pension spending.

Box IV. 1. Why is the Uncertainty of Public Debt-to-GDP so Large in San Marino?

The width of the public debt-to-GDP fanchart of San Marino, 105.3 percent, is significantly higher than in other countries. This is in contrast to other economies like France (30 percent) or Italy (37 percent) and is explained by past large bank-support provided in San Marino and the fact that it is a small economy subject to greater volatility and limited room to diversify shocks.

The key driver of debt shocks in San Marino has been the sizable bank-support provided in the past, in excess of 70 percent of GDP. For example, funds to recapitalize the state-owned-bank Cassa di Rispamio (CRSM) in 2017 amounted to 35 percent of GDP and the liquidation of former BNS added up to 18 percent of GDP. While there are still financial sector vulnerabilities, it is very unlikely that government support of such magnitudes will be needed.

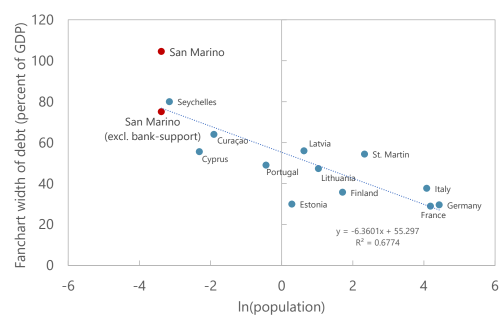
Public Debt
(Percent of GDP)



Sources: Sammarinese authorities; and IMF staff estimates.

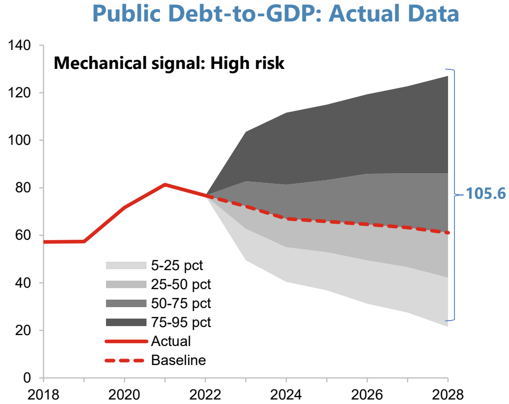
Controlling for past bank-support, fanchart width for San Marino narrows by around 30 percent. To illustrate this point, we simulated the fanchart width using adjusted public debt and primary deficits that assume no bank support. The fanchart width in this instance would be 75.7 percent of GDP (from 105.6 percent) and would result in a mechanical signal of moderate risk. The width remains relatively high, although in line with countries of similar population, reflecting the fact that San Marino is a micro, open economy subject to greater volatility and less room to diversify shocks.

Fanchart width of Public Debt and Economy Size

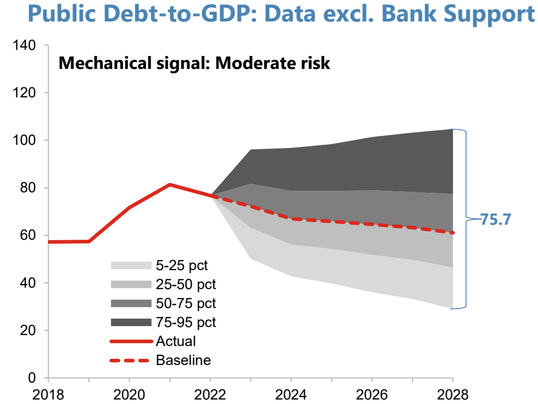


Sources: IMF staff estimates.

Public Debt-to-GDP: Actual Data



Public Debt-to-GDP: Data excl. Bank Support



11. Managing debt risks requires a credible medium-term perspective to fiscal policy including improved debt management capacity. As the current path of debt is still vulnerable to shocks, it is important to increase fiscal buffers through a more ambitious fiscal consolidation that should target a primary surplus (net of bank support) of 2.5 percent of GDP by 2027 (see paragraph 21 Staff Report). In the meantime, maintaining higher short-term liquid buffers is a priority as well as improving debt management capacity and strengthening the banking system to reduce fiscal risks. Furthermore, it will be important to develop a complementary medium-term debt strategy (MTDS) that should mitigate rollover risks and eventually incorporate the potential conversion of CRSM perpetual bonds into marketable instruments and financial sector contingent liabilities.

12. San Marino's gross external debt is set to decline on the back of continued moderate capital outflows. San Marino's gross external debt stood at 85 percent of GDP in 2022, where deposit liabilities of deposit-taking corporations accounted for the largest component. With continued capital outflows, including from the banking system, gross external debt is projected to remain on a downward trajectory over the medium-term, reaching a level of 72 percent of GDP by 2028. All else equal, lower growth, a deterioration in the current account, and a slower price growth relative to key trading partners (real exchange rate depreciation) would result in a higher trajectory of external debt relative to the baseline. The analysis is subject to several caveats reflecting data limitations including lack of FDI liabilities and the short external sector historical data.

Table IV.1. San Marino: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	**Moderate**	The overall risk of sovereign stress is moderate supported by a reduction of rollover-risks, improved fiscal outlook, and a pension reform. However, there are risks due to the spike in amortizations in 2027 as the Eurobond matures, contingent liabilities, and the long-term challenges that have not been fully addressed.
Medium term	**Moderate**	**Moderate**	Medium-term risks are assessed as moderate, despite a mechanical signal of high risk from the fanchart. This is largely driven by past government bank-support, which is unlikely to occur in such large magnitudes going forward. Overall, both the mechanical signal and final assessment point out to moderate risk. Medium term risk is assessed as moderate despite high GFN in 2027 due to the Eurobond amortization.
Fanchart	**High**	…	
GFN	**Moderate**	…	
Stress test	…	…	
Long term	…	**Moderate**	Long-term risks are moderate arising from population aging. The approved pension reform in 2022 delayed the depletion of pension assets by at least a decade (end 2037). The pension deficit is expected to deplete pension fund assets and increase public debt afterwards.
Sustainability assessment 1/	Not required for surveillance countries	Sustainable	The projected debt path is expected to decline gradually and GFNs will remain at manageable levels 5-8 percent of GDP for the next 3 years. Therefore, debt is assessed as sustainable.
Debt stabilization in the baseline			Yes

DSA Summary Assessment

Commentary: San Marino is at moderate overall risk of sovereign stress. Indicators have shown strong performance after the covid-19 shock. The outlook improved as the government has been saving revenue windfalls and keeping cautious wages and pensions indexation. Risks declined as the government built up deposits and rolled over the Eurobond maturing in 2024. Medium-term risks are assessed as moderate based on the GFN Module, despite the Fanchart module high risk signal due to sizable past bank-support. While such magnitudes of bank-support are unlikely to be needed in the future, the spike in GFN in 2027 as the Eurobond matures increases risks. Over the long-term, San Marino should continue with reforms to tackle risks arising from population aging on pension spending.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress without its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases where there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases with IMF arrangements with normal access, the qualifier indicating probability of sustainable debt ("with high probability" or "but not with high probability") is deleted before publication.

Figure IV.1. San Marino: Debt Coverage and Disclosures

						Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					Yes	
2. Subsectors included in the chosen coverage in (1) above:						

				#	Subsectors captured in the baseline	Inclusion	Comments
CPS	NFPS	GG: expected	CG	1	Budgetary central government	Yes	
				2	Extra budgetary funds (EBFs)	No	Not applicable
				3	Social security funds (SSFs)	Yes	
				4	State governments	No	Not applicable
				5	Local governments	No	Not applicable
				6	Public nonfinancial corporations	No	PNFC cannot borrow
				7	Central bank	No	
				8	Other public financial corporations	No	

						Comments
3. Instrument coverage:	Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/	IPSGSs already incorporated in
4. Accounting principles:	Basis of recording		Valuation of debt stock			
	Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/	
5. Debt consolidation across sectors:		Consolidated		Non-consolidated		

Color code: chosen coverage; Missing from recommended coverage; Not applicable

Reporting on Intra-government Debt Holdings (% of GDP)

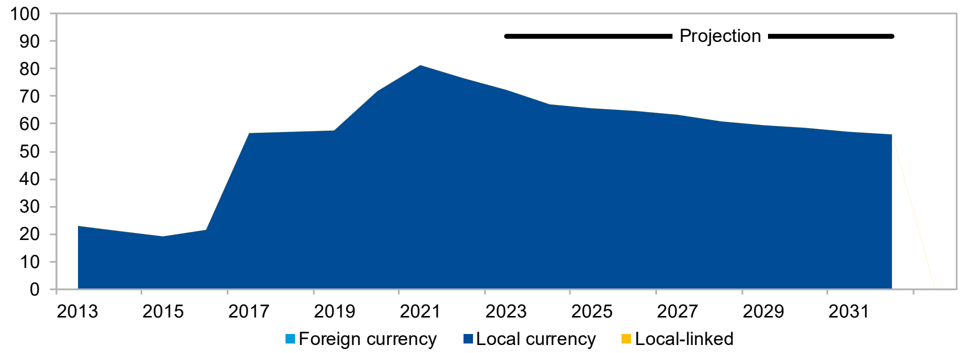
				#	Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
CPS	NFPS	GG: expected	CG	1	Budget. central govt		0	6	0	0	0	0	27	33
				2	Extra-budget. funds	0		0	0	0	0	0	0	0
				3	Social security funds	0	0		0	0	0	0	0	0
				4	State govt.	0	0	0		0	0	0	0	0
				5	Local govt.	0	0	0	0		0	0	0	0
				6	Nonfin pub. corp.	0	0	0	0	0		0	0	0
				7	Central bank	0	0	0	0	0	0		0	0
				8	Oth. pub. fin. corp	0	0	0	0	0	0	0		0
					Total	0	0	6	0	0	0	0	27	33

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Figure IV.2. San Marino: Public Debt Structure Indicators

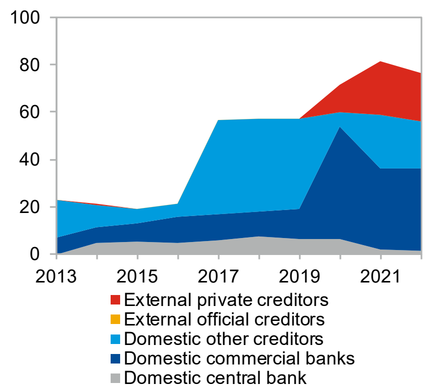
Public Debt Structure Indicators

Debt by Currency (Percent of GDP)



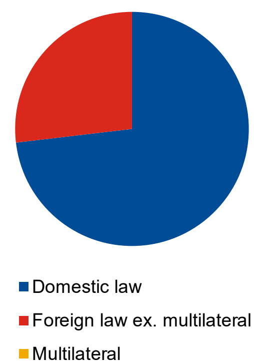
Note: The perimeter shown is central government.

Public Debt by Holder (Percent of GDP)



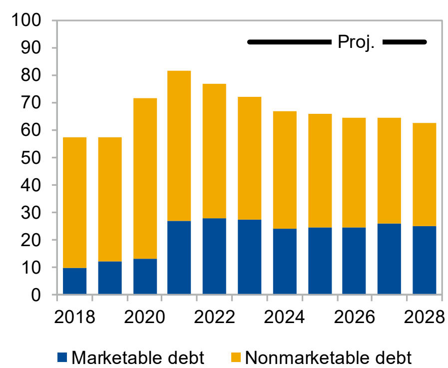
Note: The perimeter shown is general government.

Public Debt by Governing Law, 2022 (Percent)



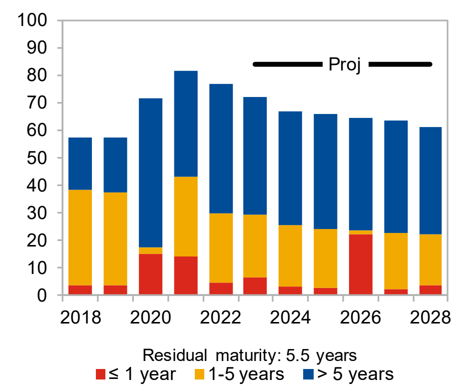
Note: The perimeter shown is general government.

Debt by Instruments (percent of GDP)



Note: The perimeter shown is general government.

Public Debt by Maturity (Percent of GDP)



Note: The perimeter shown is general government.

Commentary: Nonmarketable debt is largely explained by a perpetual bond to the state-owned domestic bank (€455 million) and forced issuance for ex-BNS depositors (€196 million).

Table IV.2. San Marino: Baseline Scenario

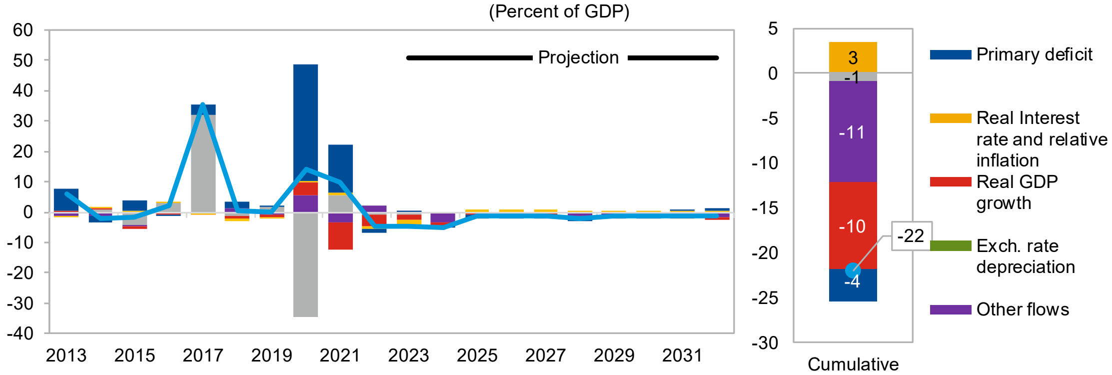
Baseline Scenario

(Percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	76.7	72.2	67.0	65.9	64.6	63.2	61.1	59.7	58.5	57.2	56.0
Change in public debt	-4.6	-4.5	-5.3	-1.1	-1.2	-1.4	-2.1	-1.4	-1.2	-1.2	-1.2
Contribution of identified flows	-3.8	-3.6	-5.3	-1.1	-1.2	-1.4	-2.1	-1.4	-1.2	-1.2	-1.2
Primary deficit	-1.3	0.0	-0.9	-1.1	-1.1	-1.0	-0.7	-0.4	0.0	0.2	0.6
Noninterest revenues	32.7	29.5	29.0	29.5	29.5	29.6	29.6	29.7	29.8	29.8	29.9
Noninterest expenditures	31.4	29.5	28.2	28.4	28.4	28.6	28.9	29.3	29.8	30.0	30.5
Automatic debt dynamics	-4.7	-3.8	-1.2	0.0	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Real interest rate and relative inflatio	-0.8	-2.1	-0.2	0.8	0.8	0.7	0.6	0.6	0.6	0.6	0.5
Real interest rate	-0.8	-2.1	-0.2	0.8	0.8	0.7	0.6	0.6	0.6	0.6	0.5
Relative inflation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Real growth rate	-3.9	-1.7	-0.9	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.7
Real exchange rate	0.0	…	…	…	…	…	…	…	…	…	…
Other identified flows	2.1	0.2	-3.2	0.0	-0.1	-0.3	-1.2	-0.8	-1.0	-1.3	-1.6
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	2.1	0.2	-3.2	0.0	-0.1	-0.3	-1.2	-0.8	-1.0	-1.3	-1.6
Contribution of residual	-0.8	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Gross financing needs	13.2	22.2	7.6	3.9	3.7	22.5	3.9	5.8	4.7	19.6	7.2
of which: debt service	14.5	22.2	8.5	5.0	4.8	23.5	4.6	6.2	4.7	19.4	6.7
Local currency	14.5	22.2	8.5	5.0	4.8	23.5	4.6	6.2	4.7	19.4	6.7
Foreign currency	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memo:											
Real GDP growth (percent)	5.0	2.2	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3
Inflation (GDP deflator; percent)	2.8	6.1	3.5	1.9	1.9	2.0	2.0	2.0	2.0	2.0	2.0
Nominal GDP growth (percent)	7.9	8.4	4.8	3.2	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Effective interest rate (percent)	1.8	3.1	3.1	3.2	3.2	3.1	3.0	3.0	3.0	3.0	3.0

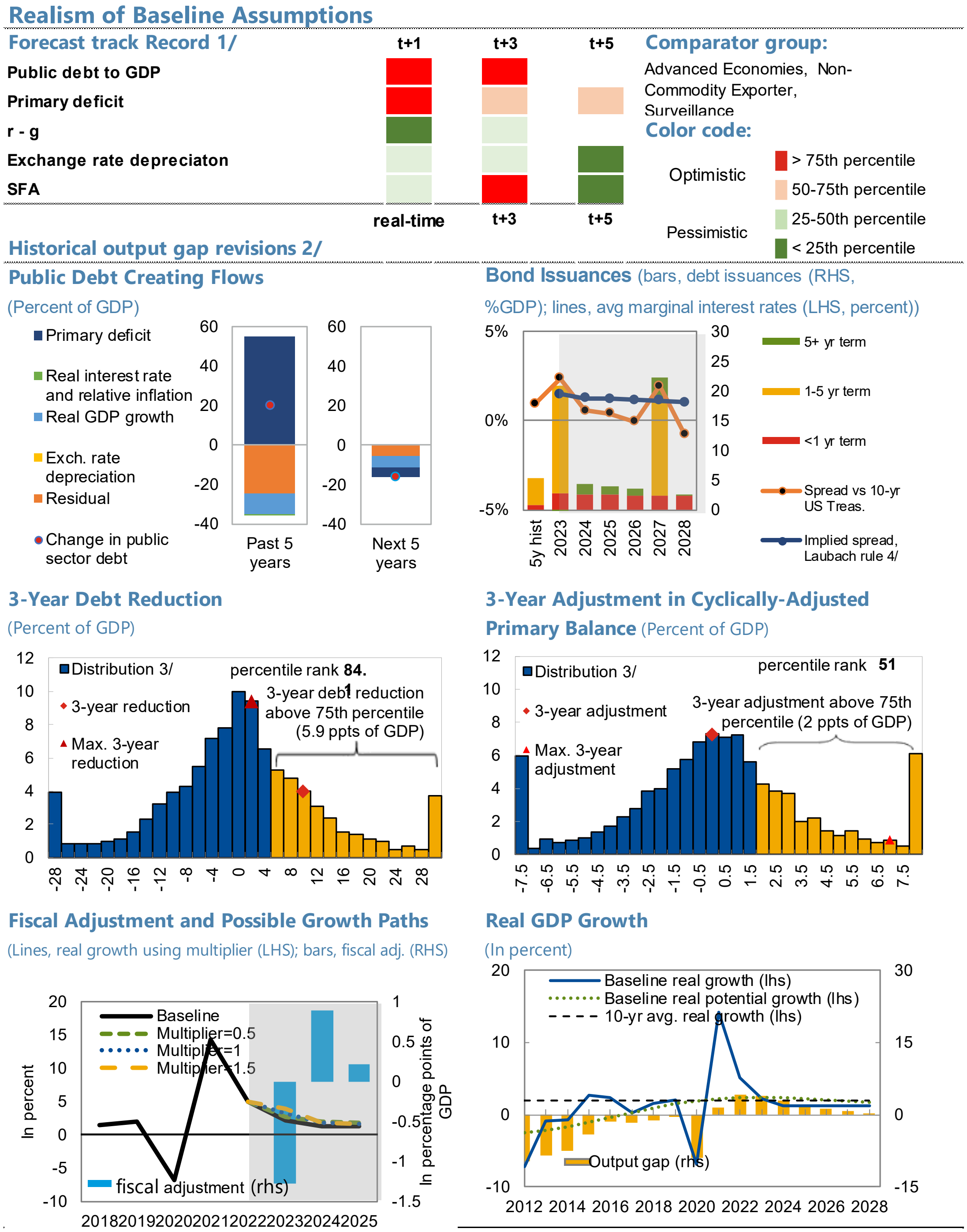
Contribution to Change in Public Debt

(Percent of GDP)



Staff commentary: Public debt will decline fast until 2024, reflecting that government keeps indexation of wages and pensions below inflation, as inflation moderates the decline of public debt to GDP slowsdwon. The high GFN in 2023, 2027, and 2031 are explained by the amortization of the Eurobond.

Figure IV.4. San Marino: Realism of Baseline Assumptions



1/ Projections made in the October and April WEO vintage.

2/ Calculated as the percentile rank of the country's output gap revisions (defined as the difference between real time/period ahead estimates and final estimates in the latest October WEO) in the total distribution of revisions across the data sample.

3/ Data cover annual observations from 1990 to 2019 for MAC advanced and emerging economies. Percent of sample on vertical axis.

4/ The Laubach (2009) rule is a linear rule assuming bond spreads increase by about 4 bps in response to a 1 ppt increase in the projected debt-to-GDP ratio.

Commentary: Realism analysis is affected by the sizable bank-support observed in the past. This bank-support explains the large forecast errors in public debt, primary deficit and SFA, flagging optimism in past forecasts. However, such bank support is unlikely to occur in comparable magnitudes looking forward. The high debt reduction in 2023-25 is largely attributed to the high GDP deflator growth combined with prudent policies on wages and pensions indexation.

Figure IV.5. San Marino: Medium-term Risk Analysis

Medium-term Risk Analysis

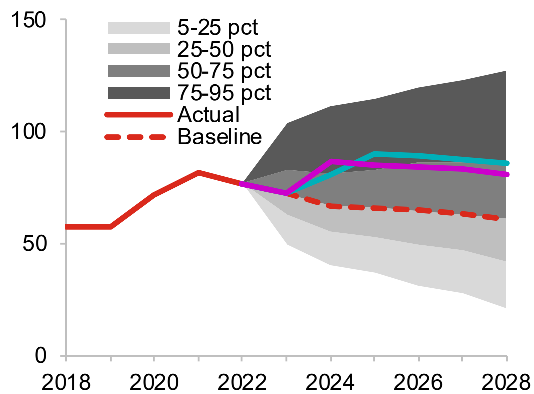
Debt Fanchart and GFN Financeability Indexes

(Percent of GDP unless otherwise indicated)

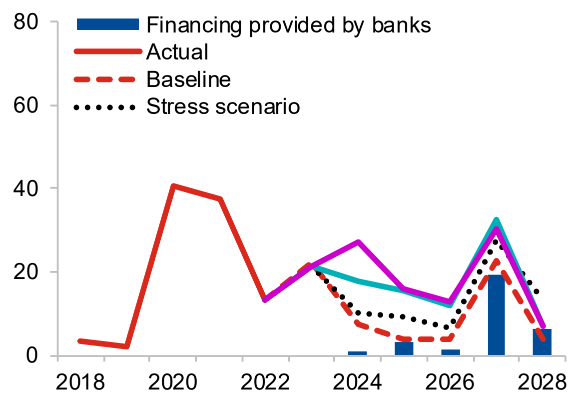
Module	Indicator	Value	Risk index	Risk signal	Adv. Econ., Non-Com. Exp, Program (0 25 50 75 100)
Debt fanchart module	Fanchart width	105.6	1.5	…	
	Probability of debt not stabilizing (pct)	33.5	0.3	…	
	Terminal debt level x institutions index	29.0	0.6	…	
	Debt fanchart index	**…**	**2.4**	**High**	
GFN finance-ability module	Average GFN in baseline	10.6	3.6	…	
	Bank claims on government (pct bank assets)	10.3	3.4	…	
	Chg. in claims on govt. in stress (pct bank assets)	7.8	2.6	…	
	GFN financeability index	**…**	**9.6**	**Moderate**	

Legend: Interquartile range; San Marino

Final Fanchart (Pct of GDP)



Gross Financing Needs (Pct of GDP)

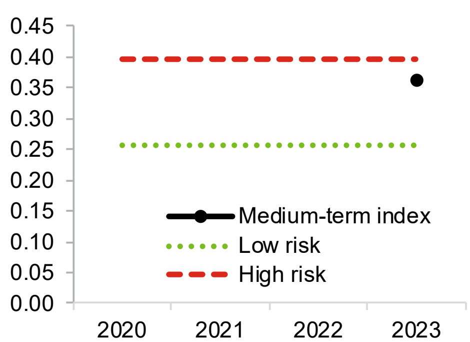


Triggered stress tests (stress tests not activated in gray)

Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term Index

(Index number)



Medium-term Risk Analysis

	Low risk threshold	High risk threhsold	Weight in MTI	Normalized level
Debt fanchart index	1.1	2.1	0.5	0.5
GFN finaceability index	7.6	17.9	0.5	0.2
Medium-term index (MTI)	0.3	0.4	…	0.4, Moderate

Prob. of missed crisis, 2023-2028 (if stress not predicted): 27.3 pct.

Prob. of false alarm, 2023-2028 (if stress predicted): 17.0 pct.

Commentary: Of the two medium-term tools, the Debt Fanchart Module is pointing to high level of risk, while the GFN Financeability Module suggests moderate despite the high GFN in 2027 due to the Eurobond amortization. Overall, the team assesses the risk as moderate (See box IV. 1).

Figure IV.6. San Marino: Long-term Risk Analysis

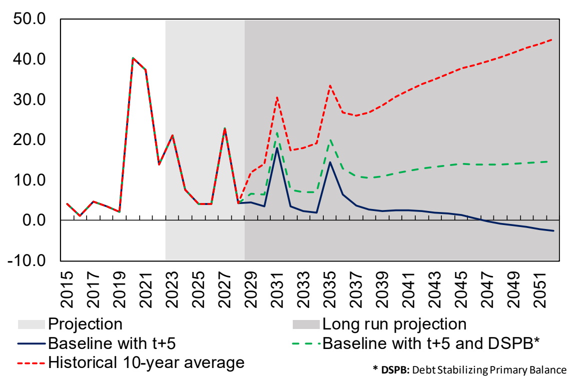
Large Amortization Trigger

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Medium-term extrapolation with debt stabilizing	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Historical average assumptions	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	

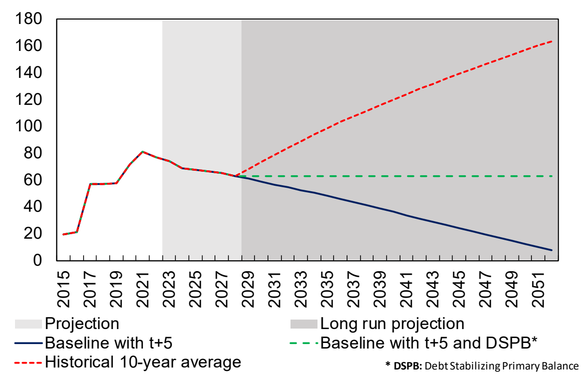
Overall Risk Indication	

Alternative Baseline Long-term Projections

GFN-to-GDP ratio



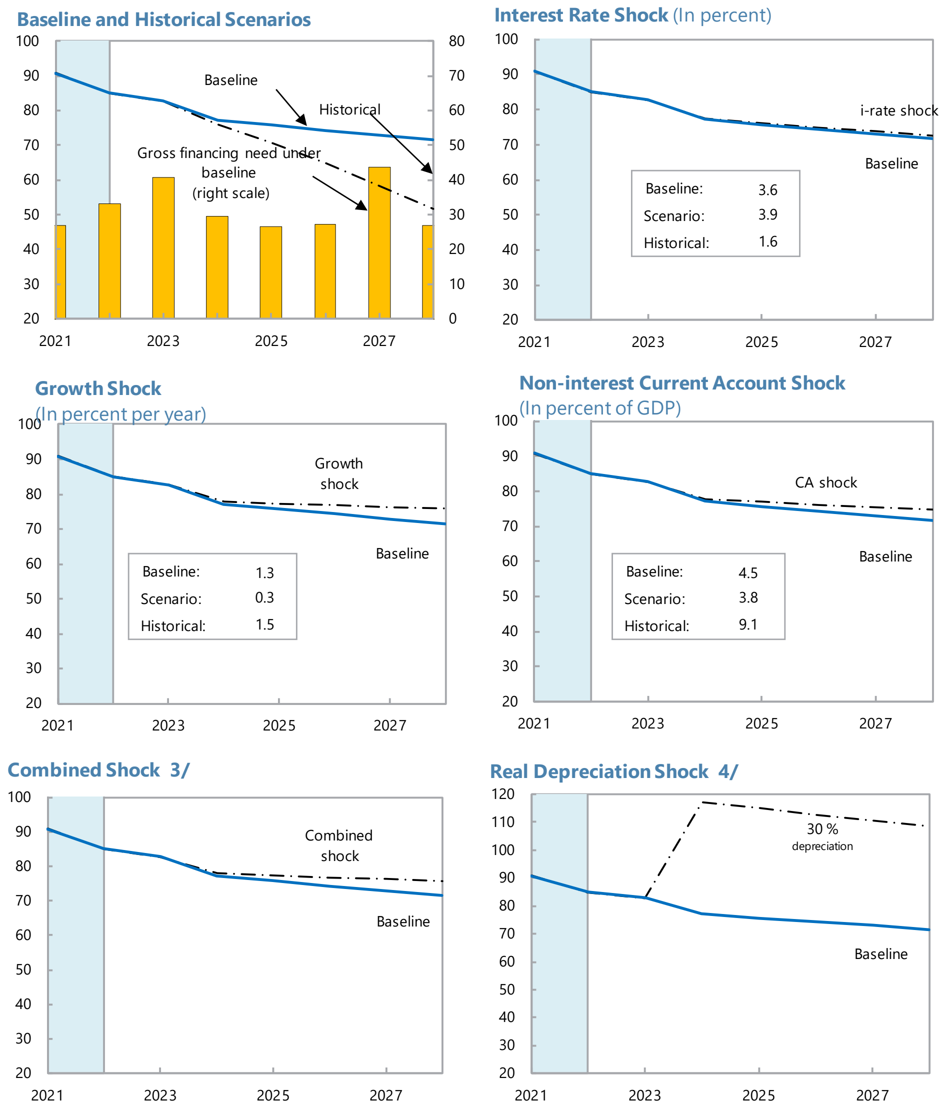
Total Public Debt-to-GDP Ratio



Commentary: The module flags high risks for debt rollover in line with the medium-term analysis (due to the bumpy amortization profile). The template-mechanics flags a high risk of debt rollover based on deviations beyond 1-standard deviation of GFN and amortizations (from the 10-year historical average). In 2021, San Marino issued its first Eurobond with an amortization above 20 percent of GDP in 2023. Since then, San Marino has a bumpy amortization profile. Before 2023 amortizations have been moderate, so the risk signal is partly explained by bumpy amortizations.

Figure IV.7. San Marino: External Debt Sustainability: Bound Tests[1, 2]

(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2024.

Table IV.3. San Marino: External Debt Sustainability Framework, 2020–28

(In percent of GDP unless otherwise indicated)

		Actual					Projections						
	2020	2021	2022			2023	2024	2025	2026	2027	2028	Debt-stabilizing non-interest current account 6/
1	**Baseline: External debt**	**85.0**	**90.8**	**85.0**			**82.8**	**77.2**	**75.7**	**74.3**	**73.0**	**71.6**	**0.5**
2	Change in external debt	16.0	5.9	-5.9			-2.2	-5.6	-1.4	-1.4	-1.4	-1.3	
3	Identified external debt-creating flows (4+8+9)	-0.3	-20.7	-4.1			-5.2	-3.7	-2.9	-2.1	-2.0	-2.0	
4	Current account deficit, excluding interest payments	-3.7	-8.2	-9.9			-6.7	-6.0	-5.0	-4.0	-3.7	-3.6	
5	Deficit in balance of goods and services	-13.4	-17.6	-18.1			-11.4	-10.6	-10.2	-9.8	-9.7	-9.7	
6	Exports	157.9	175.7	200.3			189.1	187.9	187.4	186.7	186.4	186.2	
7	Imports	144.5	158.2	182.2			177.6	177.3	177.2	176.9	176.7	176.5	
8	Net non-debt creating capital inflows (negative)	-0.8	0.1	0.2			0.2	0.2	0.2	0.2	0.2	0.2	
9	Automatic debt dynamics 1/	4.2	-12.6	5.6			1.3	2.0	1.9	1.7	1.5	1.4	
10	Contribution from nominal interest rate	0.9	1.7	1.9			2.9	3.0	2.8	2.6	2.4	2.3	
11	Contribution from real GDP growth	4.9	-10.0	-4.8			-1.7	-1.0	-1.0	-1.0	-0.9	-0.9	
12	Contribution from price and exchange rate changes 2/	-1.7	-4.3	8.4			...	...	...	...	...	...	
13	Residual, incl. change in gross foreign assets (2-3) 3/	16.3	26.6	-1.7			3.0	-1.9	1.4	0.7	0.6	0.7	
	External debt-to-exports ratio (in percent)	53.8	51.7	42.4			43.8	41.1	40.4	39.8	39.1	38.5	
	Gross external financing need (in billions of US dollars) 4/	0.5	0.5	0.6			0.8	0.6	0.6	0.6	1.0	0.6	
	in percent of GDP	31.0	26.8	33.1	10-Year	10-Year	40.9	29.7	26.6	27.1	43.6	26.8	
	Scenario with key variables at their historical averages 5/						**82.8**	**76.1**	**70.9**	**64.9**	**58.2**	**51.5**	**0.3**
	Key Macroeconomic Assumptions Underlying Baseline				Historical Average	Standard Deviation							
	Real GDP growth (in percent)	-6.8	14.2	5.0	1.5	1.9	2.2	1.3	1.3	1.3	1.3	1.3	
	GDP deflator in US dollars (change in percent)	2.5	5.3	-8.5	-0.5	7.6	10.1	4.7	2.3	2.2	1.6	1.6	
	Nominal external interest rate (in percent)	1.3	2.4	2.0	1.6	0.6	3.9	3.9	3.8	3.6	3.3	3.2	
	Growth of exports (US dollar terms, in percent)	-5.5	33.9	9.6	5.2	7.5	6.2	5.4	3.4	3.1	2.7	2.8	
	Growth of imports (US dollar terms, in percent)	-6.9	31.7	10.7	4.9	9.1	9.7	5.9	3.6	3.4	2.8	2.8	
	Current account balance, excluding interest payments	3.7	8.2	9.9	9.1	1.2	6.7	6.0	5.0	4.0	3.7	3.6	
	Net non-debt creating capital inflows	0.8	-0.1	-0.2	0.0	0.5	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

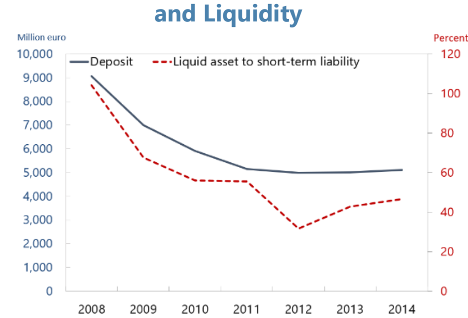
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Annex V. The San Marino Banking Crisis and its Impact on the Real Economy[1]

Since the global financial crisis, the financial sector of San Marino has experienced a series of shocks whose magnitude and persistency are among the worst in the history of financial crisis, and much of the damage on the financial sector's value added is irreversible. However, the non-financial sector has proven more resilient than could have been expected. Access to foreign credit, strong nonfinancial sector balance sheets and policy interventions mitigated the impact of the financial crisis on the rest of the economy.

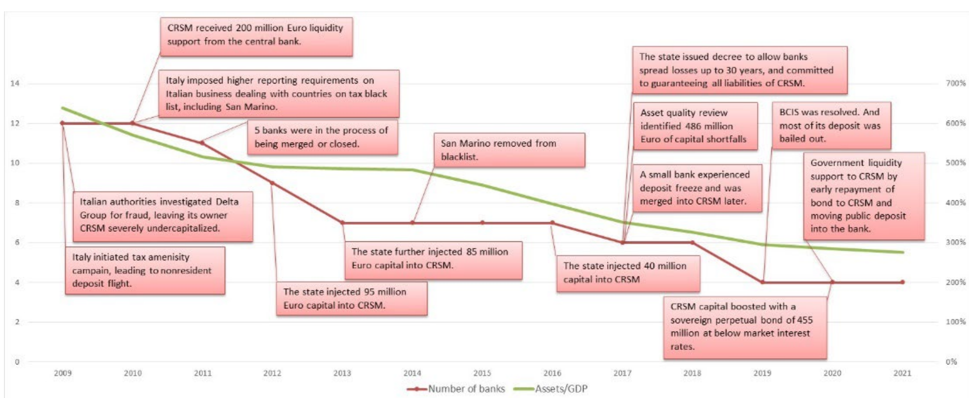
1. **The global crackdown on tax avoidance by the OECD and Italian authorities ended San Marino's outsized banking sector business model based on nonresident depositors**. After subsequent rounds of liquidity support and state recapitalization of banks, the number of banks in San Marino declined from 12 to 4, and banks' total assets have gradually declined below 300 percent of GDP from over 600 percent of GDP in 2009.[2] With Italy adding San Marino to the 'black list' of countries with preferential tax regimes during 2010-14, the majority of non-resident depositors left the banking system reducing the liquidity of the system to low levels. During this period banks' value added declined by more than 80 percent (Figure V. 3a) and, unlike most other countries that have experienced large banking crisis, has not recovered, even partially, since.[3]

Figure V.1. San Marino Banks' Deposit and Liquidity



Sources: Country authorities and staff calculates

Figure V.2. Evolution of San Marino's Banking Sector and Policy Interventions



Number of banks (LHS); bank asset to GDP ratio (RHS). Source: Past IMF staff reports and CBSM documents.

[1] Prepared by Ritong Qu and Borja Gracia.

[2] Sammarinese banking crisis is the most severe in terms of peak NPL ratio to gross loan ratio (61 percent) and fiscal outlay to GDP ratio (74 percent) among banking crises post 2007, according to Laeven, Luc, and Fabian Valencia. "Systemic banking crises database II." IMF Economic Review 68 (2020): 307-361.

[3] See Jeasakul, Zoli and Pratt (2011) Republic of San Marino: Selected Issues for the 2010 Article IV Consultation for more detailed description of the business model of secrecy banking.

2. Banks' gradual and painful deleveraging process had negative spillovers to the nonfinancial sector compounded by Italian blacklisting of San Marino. Being part of the 'blacklist' imposed onerous requirements on Italian businesses, including banks, dealing with San Marino nonfinancial companies. Thus, San Marino's non-financial sector suffered a prolonged and deep recession from 2008 to 2014 when the value added fell by 17 percent. During this period the number of manufacturing firms declined by 20 percent. Once San Marino was removed from the 'blacklist' in 2014, the non-financial sector started a gradual but sustained recovery both in the number of firms as well as value added.

Figure V.3a. Advanced European Countries' Banking Sector Value Added

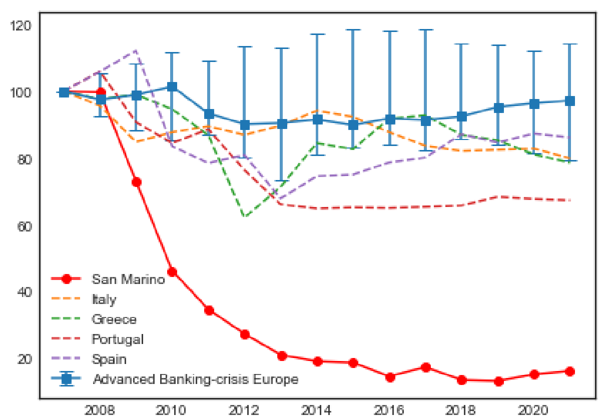
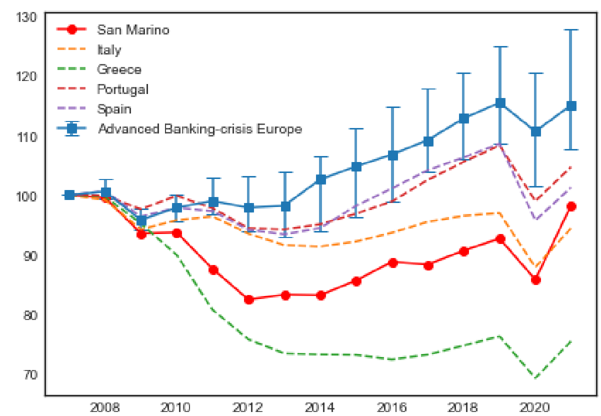


Figure V.3b. Advanced European Countries' Nonfinancial Sector Value Added



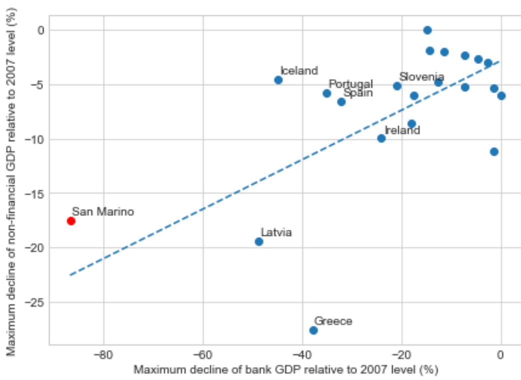
The 2007 values are normalized to 100. The levels are in real terms. The blue line is the median across all advanced EUR economies that experienced financial crisis after 2007. The whiskers indicate 20% and 80% quantiles.

Source: Fitch, DataStream, San Marino authorities and staff estimates.

3. International experience with other financial crisis suggests that the impact on the non-financial sector could have been even more significant in San Marino. Banking crises spillover to the non-financial sectors of the economy given the impact on the efficient allocation of resources through lending. We look at the trough of non-financial real GDPs against the trough of banking sector real GDP relative to the 2007 level, among advanced European economies (excluding San Marino) that experienced systemic banking crisis after 2007 (Figure V. 4). This simple exercise suggests that the impact on the non-financial sector in San Marino could have been 5 percentage points of GDP larger given the size of the shock to the financial sector. Furthermore, several factors suggest that the impact should have been even larger: San Marino non-financial corporations suffered at the same time the impact of the 'blacklist' limiting access to Italian markets and funding sources; and nonlinearities suggest that the impact could be higher given the unprecedented magnitude of the loss of value added in the banking sector in San Marino. In fact, a recovery of the non-financial sector started after 2014 and has intensified since 2019 when growth performance has significantly exceeded expectations. This positive growth performance was resilient to unprecedented shocks including covid and the war. As Figure 3b shows, while it took San Marino much longer, the non-financial sector has exceeded the pre-GFC value added in 2021 outstripping

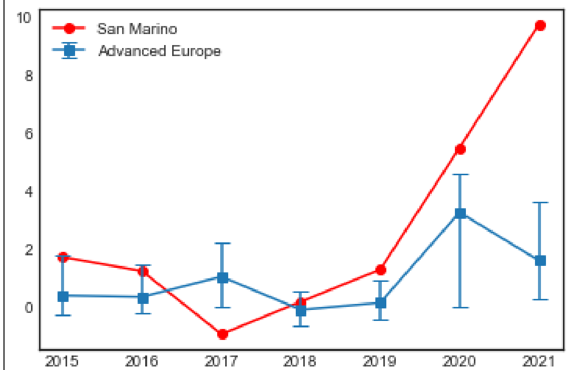
Italy's performance and getting close to the experience in Spain. These countries have suffered banking crisis that, while significant, are much smaller than the one experienced in San Marino.

Figure V.4. Trough of Nonfinancial GDP Loss vs. Trough of Financial GDP Loss



Source: San Marino authorities and staff estimates.

Figure V.5. Spring WEO Forecast Errors of San Marino Current-Year Real GDP Growth

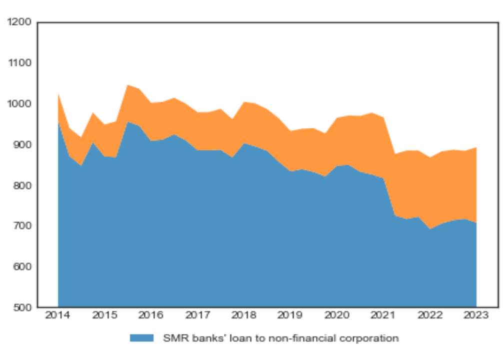


Source: IMF staff calculates

What explains the relative positive performance of the non-financial sector in San Marino given the unprecedented banking crisis?

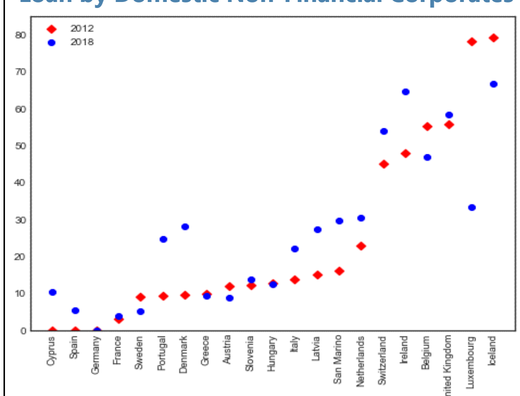
4. **Manufacturing exporting companies in San Marino are highly integrated in the surrounding region of Emilia Romagna providing access to Italian markets and banks**. San Marino and Italy share an open border, and many large local firms have operations on both sides of the border providing smooth access to Italian banks. Foreign loan to Sammarinese non-financial corporations increased by 170 percent from end-2013 to end-2022. Thus, large Sammarinese companies have maintained access to funding from Italian banks even when local banks were not providing new lending. Firm balance sheet data shows the proportion of external loans relative to total financial liabilities doubled during the period of 2012 to 2018 (Figure V. 6 and V. 7).

Figure V.6. External Financing to San Marino



Source: San Marino authorities, BIS.

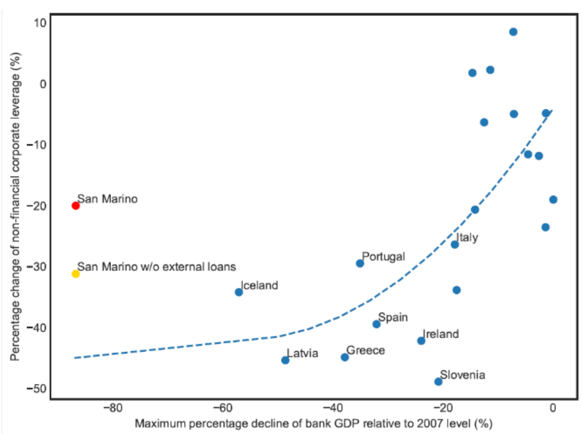
Figure V.7. External Loan as Proportion of Total Loan by Domestic Non-Financial Corporates



Source: Haver analytics, and staff estimates.

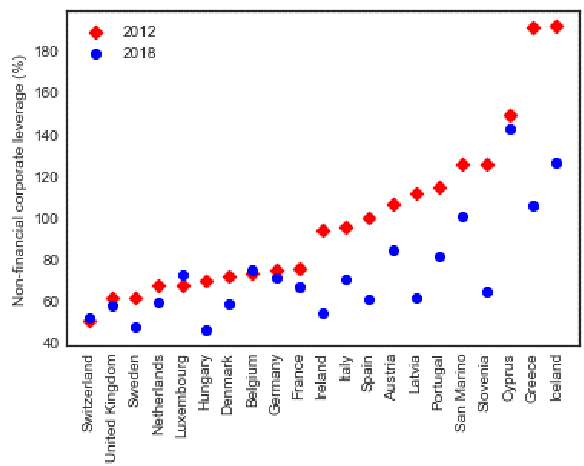
5. **Big manufacturing companies in San Marino have strengthened their balance sheet since 2014**. Based on firm balance sheet data available from 2012 to 2018, aggregate non-financial leverage declines from 125 percent to 100 percent. As shown in Figure V. 8, the deleveraging of Sammarinese firms is lower than in other European countries whose bank value added shrank by much less. This process has been facilitated by access to credit in Italy at conditions similar to Italian corporates and prevented a more drastic deleveraging—foreign funding could have prevented an additional 12 percent decline in non-financial firms' aggregate leverage (Figure V. 8).

Figure V.8. Advanced European Countries' Deleveraging of Non-Financial Corporates vs. Trough of Nonfinancial GDP Loss



Source: San Marino authorities and staff estimates.

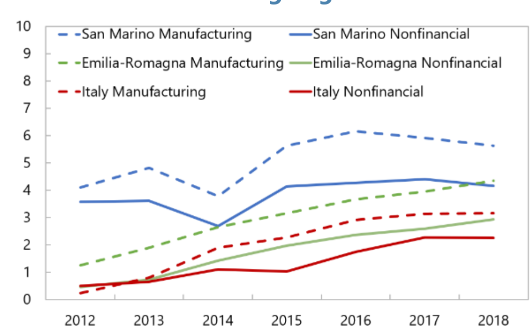
Figure V.9. Advanced European Countries' Corporate Debt to Equity Ratio, 2012 vs. 2018



Source: San Marino authorities and staff estimates.

6. **Sammarinese manufacturing companies are structurally more profitable than Italian peers**. The manufacturing sector has been an engine of growth accounting for a third of GDP, 30 percent of employment and contributing to more than half of GDP growth since 2015. Sammarinese companies have benefitted from being integrated into the Emilia-Romagna region and having a more competitive corporate tax regime than their Italian peers. The aggregate ROA of the manufacturing sector is greater than that of Emilia-Romagna's which is higher than Italy's average (Figure V. 10).

Figure V.10. Return of Assets, San Marino and Surrounding Regions



Source: Orbis, country authorities and IMF staff

Higher profitability has enabled the manufacturing sector to diversify its funding by investing its retained earnings—equity growth from 2012 to 2018 was 40 percent (Figure V. 11). This has resulted in lower leverage for manufacturing companies in San Marino than those in countries experiencing less severe banking crisis (Figures V. 9 and V. 12).

Figure V.11. Sectoral Equity Growth and Debt Growth, 2012 vs. 2018

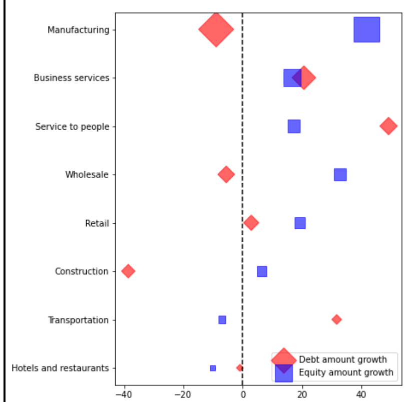
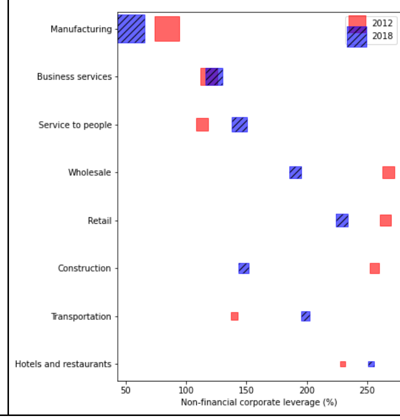


Figure V.12. Sectoral Debt to Equity Ratio



The size of each point is in proportion to value added.

Source: Country authorities and staff estimates

7. **Albeit at huge fiscal cost, policy intervention largely isolated the nonfinancial corporate and household sectors from the negative spillover of the banking crisis**. Large losses were transferred from the financial sector to the public sector—public debt increased from 15.5 percent in 2008 to more than 81 percent in 2020. Most of the fiscal support was used to recapitalize banks while bailing out uninsured depositors. However, these bailouts avoided a large negative impact on consumer confidence and the likely negative impact on the solvency of small firms. Furthermore, the potentially extended period of tight deposit and capital controls that might have been required, would have delayed the economic recovery complicating the needed fiscal adjustment. The massive public sector intervention was not complemented by a meaningful restructuring of the banking sector that remained oversized and inefficient while unable to provide credit to the private sector—Sammarinese banks experienced eleven consecutive years of negative profitability and kept contracting credit to the economy. In any case, the potential benefits of this approach should be weighed in against its large cost to taxpayers—one of the largest in the history of financial crisis in percent of GDP—and the associated equity and intergenerational impact.

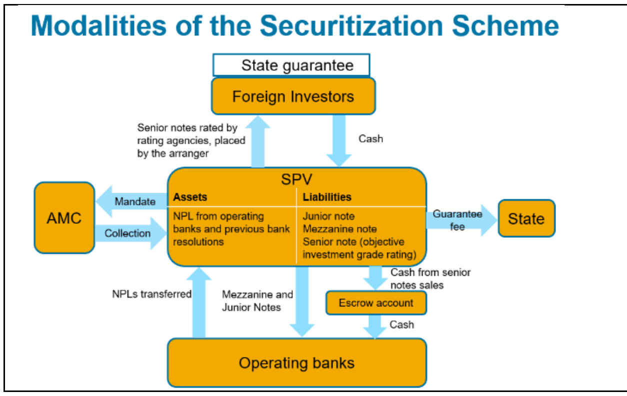
Reflection on the San Marino Banking Crisis

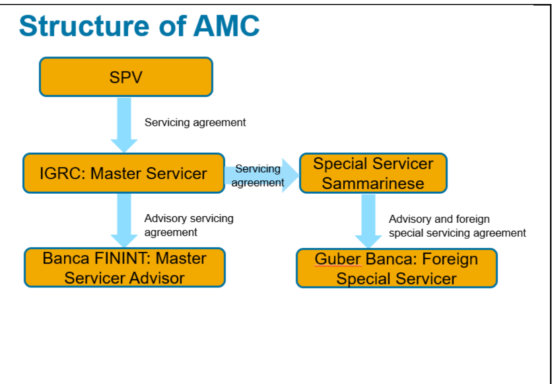
8. **The experience in San Marino is unique in that domestic banks are not key in the intermediation of savings into productive investment**. Despite a weak banking system, the non-financial sector has achieved a remarkable growth performance since 2014, resilient to covid and the recent shock to the terms-of-trade. While the country has gone a long way to address the structural issues in the financial sector, further is needed to complete the financial sector reform and put San Marino banks in a strong footing to support growth again. However, a small domestic market and access to Italian banks by big manufacturing companies limit the business opportunities in San Marino. These opportunities concentrate on small businesses and households with no access to Italian banks due to large information asymmetries and potentially large transaction and enforcements costs. Notwithstanding significant consolidation since 2008, the banking system remains oversized to fit into such a small market.

Annex VI. Asset Management Company[1]

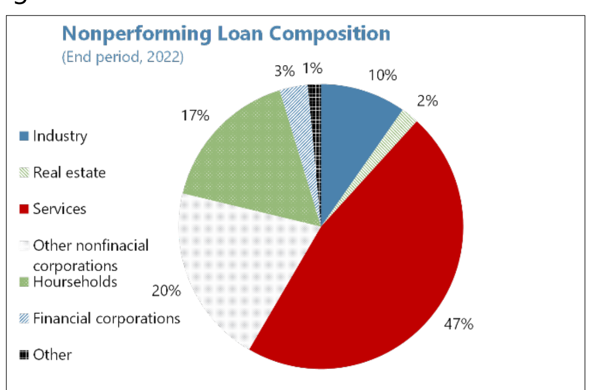
The main legislative framework for securitization has been set up and the arrangers, servicers, and rating agencies for the asset management company (AMC) have been already selected.[2]

- **Governance:**
  - A special purpose vehicle (SPV) has been established to securitize NPLs. The SPV is managed by a board of directors appointed by parliament.
  - The AMC is owned by local banks and the state, in partnership with the arranger (JP Morgan), the master servicer (IGRC), master servicer advisor (Banca FININT), the Italian servicer (Guber Banca), and a local servicer (Special Servicer Sammarinese). IGRC is a government entity in charge of liquidating ex-BNS distressed assets. As the master servicer, IGRC will be in charge of supervisory activities, while the collections, recovery and management of the portfolio will be delegated to servicers.





- **Funding:** The SPV will acquire NPLs from banks and issue asset backed securities (ABS). The senior tranche of the ABS will have a state guarantee, in exchange, a guarantee fee will be paid to the state from the SPV The junior and mezzanine tranches of the ABS will stay in the banks' balance sheets. JP Morgan, the arranger, will arrange the sale of the senior bond to investors. The senior bond will be rated by three rating agencies, Moody's, BRS and ARC. The operational cost of the AMC will be covered by banks. In return for the NPLs transferred, the banks receive bonds backed by the underlying NPLs and cash—from the foreign subscribers of the senior bonds. Banks must keep 15 percent of the cash in an escrow account paid to the originator bank at the maturity of the senior bonds.



Sources: CBSM and IMF staff estimates.

[1] Prepared by Ritong Qu

[2] Law no.157/2021 and decree 100/2022 IGRC.

- **NPL composition:** The NPLs transferred to the vehicle are from existing banks and previous bank resolutions. Existing banks' NPLs, including NPLs that will not be transferred, are composed of 61.6 percent of nonresident loans and 38.4 percent of resident loans. In terms of sectoral compositions, corporate loans constitute 79 percent of NPLs in existing banks while household loans constitute of 17 percent.

- **Transfer pricing:**
  - The total real economic value of the transferred NPLs—defined as the discounted cash flow from the NPLs minus cost of recovery— is determined by Guber Banca based on data collected and verified by the arranger.
  - The transfer price of the NPLs will be below net book value.

- **Risk and return:**
  - The senior tranches will enjoy the state guarantee and will receive regular coupon and principal payments according to schedule.
  - The mezzanine tranches are subordinated to the senior tranches, and provide the right to receive a payment, at maturity, for an amount equal to the difference between the real economic value of the assets and the value of the senior tranches.
  - The junior tranches will give the holders the right to receive a payment, at maturity, for the positive difference, if any, between the net book value of the NPLs at the time of the transfer and the real economic value of the transferred NPLs as estimated by the arranger. The originator banks retain the right to replace those NPLs whose real economic value is lower than their net book value with other NPLs of the same value.

- **Loss distribution:** Cashflows of every individual NPL will be tracked and losses related to NPL recovery will be absorbed first by the junior bonds held by the originating bank and, if insufficient, by the mezzanine bonds and, eventually, by the reserves of the bank held in the escrow accounts, with potential additional contributions requested from the banks if needed. The state is the final backstop in case these measures are not sufficient to repay senior bonds.

- **Regulatory treatment of AMC bonds:** The design of AMC bonds' risk weight factors and transferring price of NPLs preempt large immediate banks' capital needs even if valuations are significantly below book values. The difference between net book value of NPLs and the real economic value of ABS will be gradually reflected in balance sheets through risk weight factor adjustments. The senior bonds with guarantee have risk weight factor of zero. The mezzanine bonds have risk weight factor equal to the average risk factor of the underlying NPLs. The junior bonds start with risk weight of three times the average risk factor of the underlying NPLs. Adjustments of junior bonds risk weight increase over time and decrease with the excess cash flow from underlying NPLs relative to the expectation. Meanwhile the book value of ABS will remain constant.

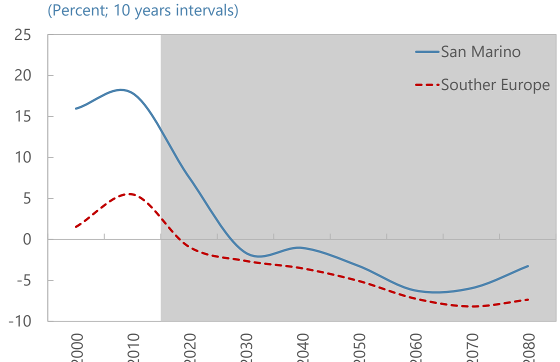
Annex VII. Migrants and Demographic Challenges[1]

Population aging is expected to impact economic activity and fiscal accounts in San Marino, by adding downward pressures on potential growth and increasing healthcare and pension spendings. Unlike other countries in Europe facing similar challenges and given its small size, San Marino has easy access to foreign workers. This offers a unique opportunity—a need of a few thousand workers among a labor force of millions surrounding San Marino—to partially offset the adverse impact of demographics. Thus, labor market flexibility is key to ensure that cross-border labor participation can mitigate the consequences of aging. However, the challenges of the pension system go beyond demographic trends and reflect generous pensions that will require additional reform efforts even if cross-border workers fully offset the negative impact of an ageing population on the labor force.

I. Demographic Challenges

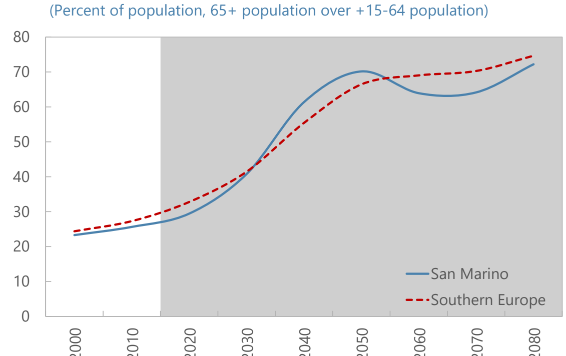
1. **Like most European economies, San Marino faces increasingly unfavorable demographic trends due to an aging population.** As stated in the 2019 Art. IV[2], population is expected to start declining by 2030, due to ageing and low fertility rates. At the same time, San Marino has one of the highest life expectancies in Europe that is projected to increase further. As a result, the dependency ratio is expected to more than double from below 30 percent to 70 percent by 2050. These demographic trends will significantly impact the fiscal accounts and productivity.

Population Growth
(Percent; 10 years intervals)



Sources: UN population prospects 2022.

Old Dependency
(Percent of population, 65+ population over +15-64 population)



Sources: UN Population Prospects 2022.

2. **An aging population is associated with lower growth and a higher fiscal burden.** Aging slows down potential growth as the working-age population declines. Also aging reduces productivity and innovation as there are less young and prime-age workers.[3] This process adds

[1] Prepared by Ezequiel Cabezon and David Velazquez-Romero.

[2] See IMF Country Report No. 19/85, Annex VI.

[3] Shekhar and Ebeke (2016) provide a discussion on aging and productivity and conclude that workforce aging will reduce total factor productivity in Europe in the next decades.

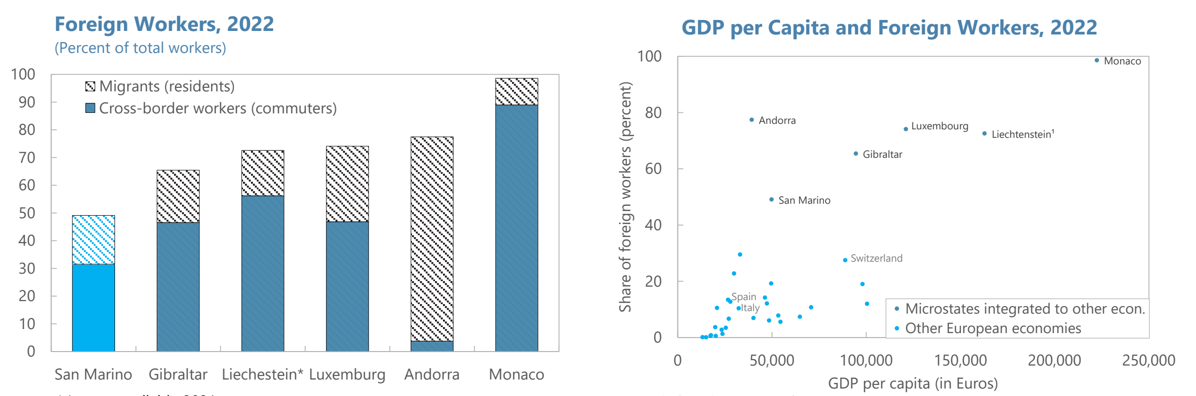
pressures on the fiscal accounts as pensions and healthcare spending step up and as the reduction in working-age population and lower growth erode the tax base.[4]

3. Migration and cross-border workers can mitigate the adverse demographic trends. First, cross-border workers can compensate the impact of a native aging population on the labor force. Second, cross-border workers can increase labor productivity as skilled workers have higher-than-average productivity and have positive spillovers on coworkers.[5] Also, cross-border workers can help mitigate shortages of unskilled workers. Unskilled cross-border workers provide flexibility to the labor market and potentially allow the reallocation of native workers to higher productivity jobs.[6]

II. The Role of Cross-border Workers in San Marino

4. San Marino is in a unique position to access foreign workers. The country is a microstate (36 thousand inhabitants) and highly integrated into one of the most dynamic economic regions of Italy. With no cultural or language barrier and no physical borders with Italy, foreign workers, particularly from Italy, have unique features that ensure a quick integration in the labor market. Foreign workers are about half all workers. There are two kinds of foreign workers in San Marino: residents (about 20 percent of employment) and those who commute daily (about 30 percent of employment). In this context, San Marino has access to a very large number of foreign workers.

Figure VII. 1. Foreign Workers and Cross-border Workers



* Lastest available 2021.
Sources: Country authorities.

1/ For Liechestein corresponds to 2021.
Sources: Eurostat and country authorities.

5. As other small economies, San Marino has relied on migration and cross-border workers. Microstates that are closely integrated into neighboring economies tend to have a large share for foreign workers. With limited size and high income these microstates face labor shortages particularly of skilled workers. San Marino's share of cross-border workers (in employment) is low among small European states, but this share is consistent with the income level of the country

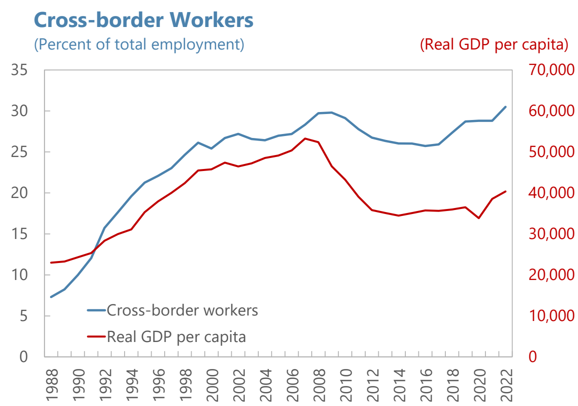
[4] Bodnár and Nerlich (2022).

[5] Hunt and Guathier-Loiselle (2010) and Peri, Shih, and Sparber (2015).

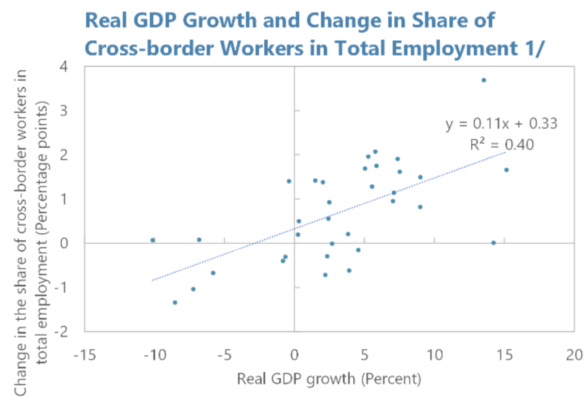
[6] Peri and Sparber (2009).

(Figure VII.1). Cross-border workers grew consistently until 2007. The share of cross-border workers increased from 7 to 30 percent between 1988 and 2007. With the global financial crisis (GFC), cross-border workers declined—and only started to recover in 2016—and have exceeded the pre-GFC peak recently (Figure VII.2). Overall, cross-border workers have been vital to support growth in San Marino, particularly in the manufacturing sector.

Figure VII. 2. Foreign Cross-border Workers



Sources: IMF staff estimates.

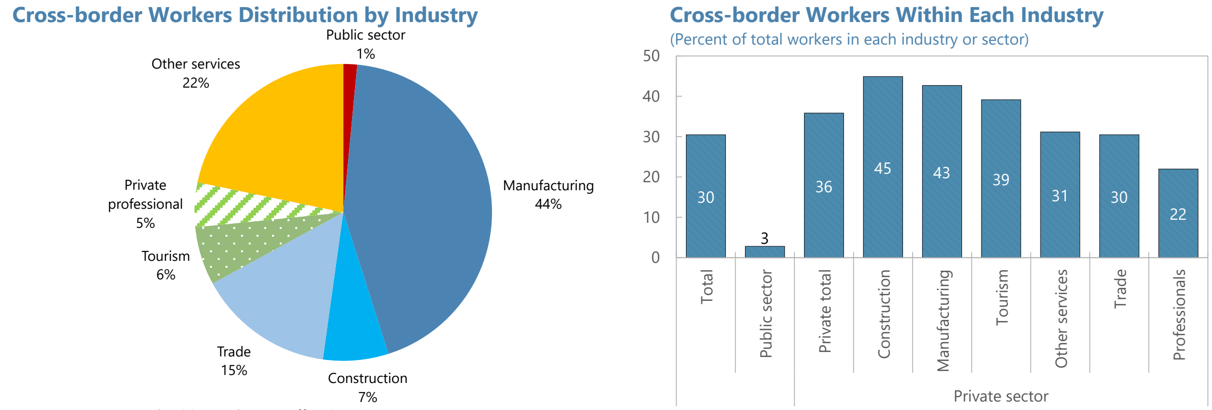


1/ Annual data covering 1989-2022.

6. Labor demand has been the main driver of cross-border workers flows in San Marino. While the supply of cross-border workers for San Marino is very elastic, demand of cross-border workers responds to cyclical and structural reasons. In cyclical terms, when firms face increases (decreases) in orders, labor demand expands (declines) and given the small native population, firms seek to hire (dismiss) foreign workers. This is reflected in the positive correlation between the variations of share of cross-border workers and real GDP growth (figure VII.2). In structural terms, given the limited size of the population and the low unemployment rate, it is challenging to find Sammarinese workers with the right skills especially in the manufacturing sector.

7. Cross-border workers are essential for the main industries of San Marino. About half of the cross-border workers are employed in the manufacturing sector and the rest are concentrated mostly in services including trade, tourism, and other services (Figure VII.3). Cross-border workers represent a sizable share of employment in several sectors such as manufacturing (43 percent), construction (45 percent), and tourism (39 percent). Importantly, cross-border workers are crucial for manufacturing and tourism which are the two main engines of growth in San Marino.

Figure VII. 3. Cross-border Workers Sectoral, 2022

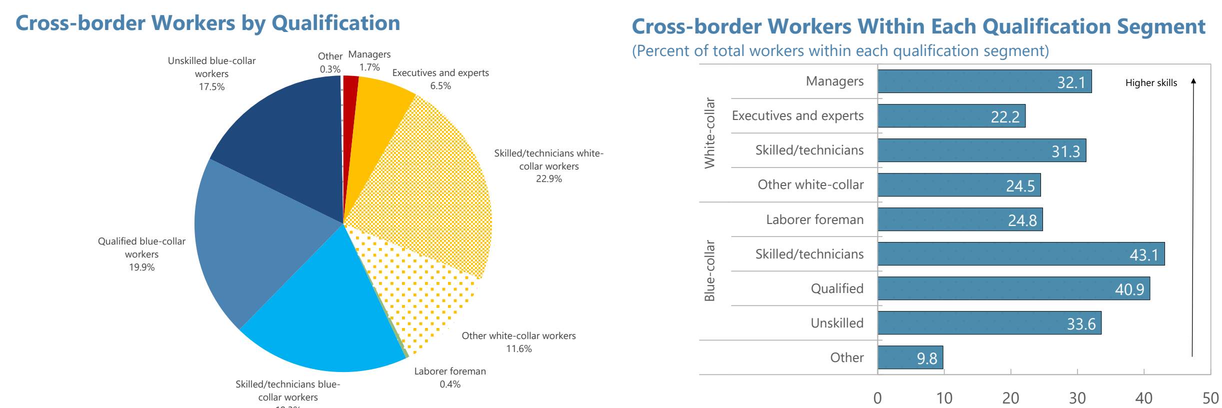


Sources: Country authorities and IMF staff estimates.

Sources: Country authorities; and IMF staff estimates.

8. Both skilled and unskilled workers are attracted to San Marino and help ease both cyclical as well as structural bottlenecks. Blue-collar workers account for about 60 percent of the cross-border workers reflecting the manufacturing labor demand (Figure VII.4). However, a large part of the blue-collars workers has specific skills or qualifications, and skilled workers white-collar workers are still an important fraction of workers. Furthermore, the share of foreign managers and experts (in percent of total managers and experts) is considerable, signaling shortages of skilled managers. This combination of skilled and unskilled workers brings positive spillovers to San Marino. Overall, unskilled cross-border workers helped to address cyclical shortages, while skilled cross-border workers helped to close structural gaps. Firms tend to smooth labor demand for skilled workers more than for unskilled workers, because skilled workers accumulate more firm-specific knowledge that is more difficult to replace.

Figure VII. 4. Cross-border Workers Skills Distributions- 2022

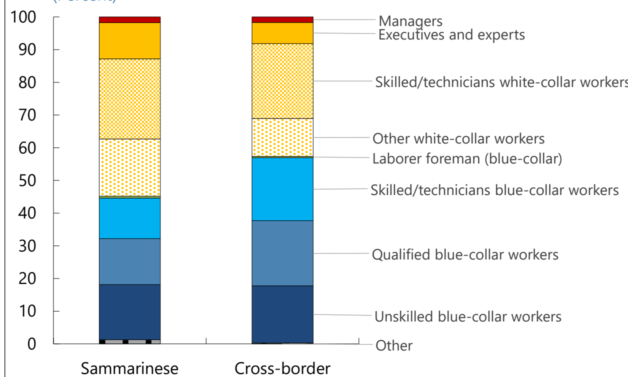


Sources: Country authorities; and IMF staff estimates.

Sources: Country authorities and IMF staff estimates.

9. Without physical borders or cultural barriers with Italy, the majority of cross-border workers are fully integrated into the labor market instantaneously. In San Marino, foreign workers do not face **many** of the challenges present in other countries. As about 90 percent of the cross-border workers are Italians, language and cultural gaps are nonexistent. Also, the distribution of skills between Sammarinese and cross-border workers is not very different avoiding potential adjustment costs. All these factors allow a rapid and efficient integration of foreign workers into the labor market, which is key to maximize positive spillovers from migrants on growth. In addition, as many of the cross-border worker are non-residents, this reduces the demand on public services such as healthcare, education, housing and other social services that could be associated with large migration flows.

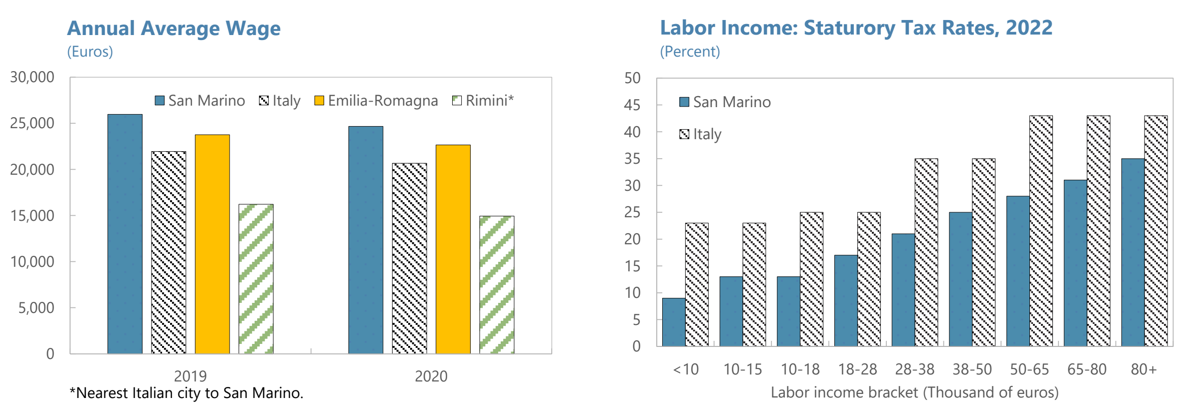
Distributions of Skills Among Workers, 2022
(Percent)



Sources: Country authorities and IMF staff estimates.

10. San Marino can attract cross-border workers given its competitive wages and tax benefits. Literature on cross-border workers documents salaries and taxes as the key driver of cross-border commuters. San Marino's gross average wages are relatively aligned with regional averages (Emilia-Romagna), but above the nearest Italian urban center (which is a tourism center). At the same time, the personal income tax rates are lower in San Marino than in Italy as are corporate income tax rates. While tax treaties aim to eliminate double taxation and tax arbitrage for workers, lower labor taxation results in lower labor costs for companies even if they offer similar post-tax wages than in Italy. Furthermore, with lower labor taxes too, profitability of San Marino manufacturing companies would be greater than their Italian competitors with similar productivity levels (See Annex V).

Figure VII. 5. Wages and Taxes Relative to Italy



*Nearest Italian city to San Marino.
Sources: Istat; San Marino Statistics Office; and IMF staff estimates.

Sources: OECD; country authorities; and IMF staff estimates.

III. Can Cross-border Workers Help Mitigate Demographic Challenges?

11. Cross-border worker have a key role to support growth in San Marino. Given its small size relative to the Italian labor market, San Marino can largely compensate adverse demographics with a relatively small number of cross-border workers. By contrast, a gross migration of 1.5 million people per year (plus an increase in the participation rate) would be needed to keep the labor force constant in Germany until 2035.[7] Following Jaumotte and others (2016), real GDP per capita is decomposed into real GDP per worker, the employment rate, and the share of the working age population rate—that proxies aging—(equation 1). This simple exercise suggests that a relatively small increase in cross-border workers from 6,900 to 8,400 would be sufficient to keep potential real growth constant in the next decade. Furthermore, in an extreme scenario if cross-border workers remain at 30 percent of total workers, real GDP growth per capita could become negative in the next decade.

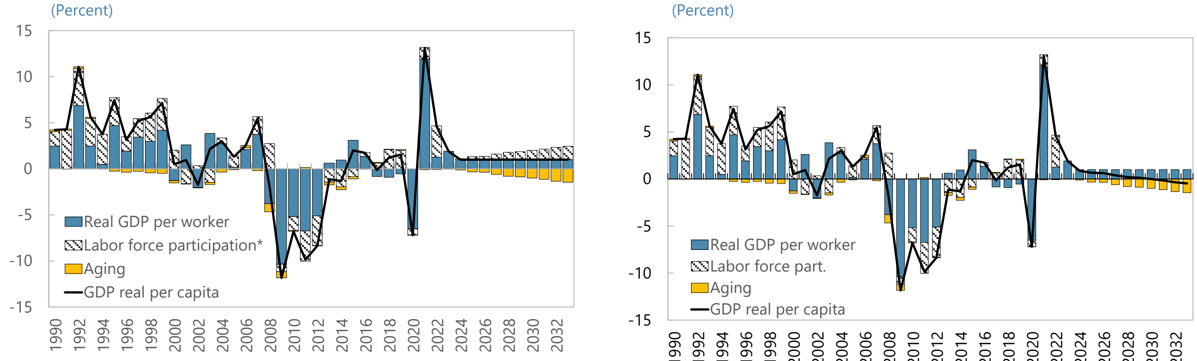
$$\Delta ln\left(\frac{GDP}{population}\right) = \Delta ln\left(\frac{GDP}{workers}\right) + \Delta ln\left(\frac{Sammarinese\ Workers + cross\ border\ Workers}{Working\ age\ pop.}\right) + \Delta ln\left(\frac{Working\ age\ pop.}{population}\right) \qquad \text{(equation 1)}$$

$$\Delta ln\left(\frac{GDP}{population}\right) = \Delta ln(labor\ productivity) + \Delta ln(employment\ rate) + \Delta ln(share\ of\ working\ age\ pop.) \qquad \text{(equation 2)}$$

Figure VII. 6. Growth Decomposition

Baseline: Real GDP per Capita Growth (Percent)

Adverse Scenario: Real GDP per Capita Growth (Percent)



* largely driven by cross-border workers growth
Sources: IMF staff estimates.

Sources: IMF staff estimates.

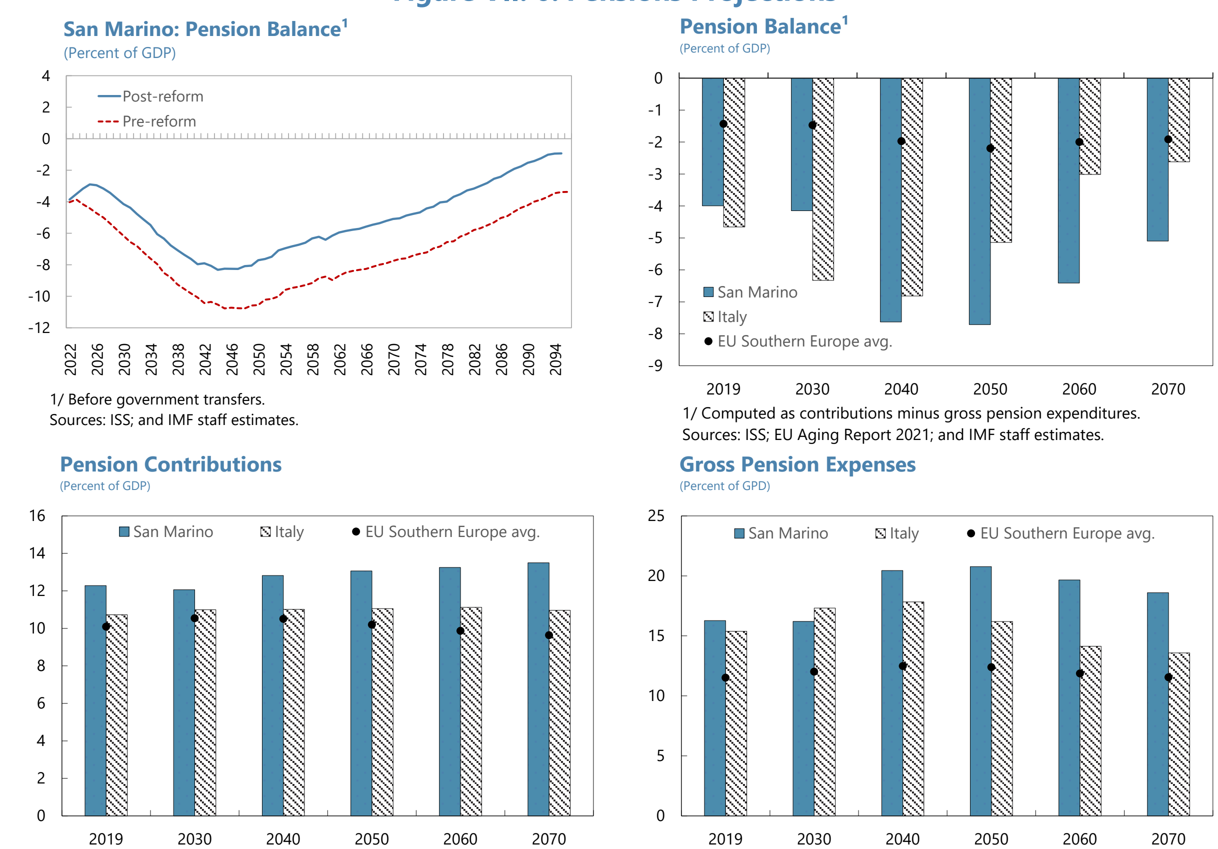
[7] Fuchs, J., D. Söhnlein and B. Weber (2021)

Table VII. 1. Selected Indicators
(Percent)

	2013 -> 2023	2023 -> 2033
Real GDP growth (annual)	2.2	1.3
Real GDP growth per worker (annual)	1.2	1.0
Population growth (annual)	0.4	0.3
Workers' growth (annual)	1.0	0.4
Sammarinese	0.4	-0.5
Cross-border	2.5	1.9
Share of population 15-64 (initial -> end)	67.2 -> 66.8	66.8 -> 61.6
Share of cross-border workers: (initial -> end)	26.3 -> 30.5	30.5 -> 35.9

12. **In addition, adverse demographics will put pressure in the sustainability of the pension system notwithstanding the recent reform.** With population aging and generous benefits, the Sammarinese pensions deficit is expected to increase to unsustainable levels until early in the 2040s. The deficit of the Sammarinese pension system is projected to be larger than countries in the region. With demographic trends that are largely similar, this is largely driven by very generous pensions, much higher than in the region. The pension reform approved last year has improved the situation by increasing contributions but has not addressed the benefit side of expenditure.

Figure VII. 6. Pensions Projections



1/ Before government transfers.
Sources: ISS; and IMF staff estimates.

1/ Computed as contributions minus gross pension expenditures.
Sources: ISS; EU Aging Report 2021; and IMF staff estimates.

Sources: ISS; EU Aging Report 2021; and IMF staff estimates.

Sources: ISS; EU Aging Report 2021; and IMF staff estimates.

13. To mitigate demographic challenges on growth, it will be key to enhance labor market flexibility for cross-border workers further. Restrictions on cross-border workers not only reduce flexibility in the labor market and the capacity to absorb macroeconomic shocks. At the same time they are unlikely to protect domestic employment since domestic and cross-border workers are complementary. Therefore, further flexibility should encourage cross-border labor participation and hiring. Flexibility can be enhanced by removing higher social contributions on fixed-term contracts over the 18-to-24 months that disincentivize these contracts. Similarly, restrictions on temporary work agencies depending on the level of unemployment should be lifted as they may prevent the actual establishment of such agencies. Finally, restrictions on the hiring of cross-border workers depending on the sectoral level of unemployment should also be removed.

14. Even if cross-border workers could fully compensate for aging in the labor force, the sustainability of the pension system still requires a parametric reform over the next decade. The challenges of the pensions system require rationalizing benefits including by increasing penalties for early retirement, linking benefits to the full career contributions (not the last 30 years), and linking the retirement age to life expectancy (See Annex VI in IMF Country Report No. 19/85).

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Annex VIII. Autonomous State Agency for Public Services

San Marino had electricity and natural gas tariffs unchanged for the last decade. Until late 2021, the business model was that energy tariffs were constant and AASS hedged the cost of energy. Also, tariffs were above recovery cost as profits from energy supply were used to subsidize other services.[1] Thus customers were not familiar with significant fluctuations in energy tariffs.

With high volatility in energy prices, a new tariff system was needed. The fixed tariff model prevalent over many years became unviable given the high volatility of energy prices. AASS recorded a balance in 2022 thanks to hedging, but there was a need to increase tariffs to cost recovery levels. When planned tariff hikes were about to be phased-in, global energy prices started to decline. The authorities recalibrated the energy strategy by increasing tariffs to cost recovery and indexed them to Italian wholesale energy prices. This implied a radical change for customers as tariffs started to be adjusted monthly.

San Marino: Tariff Adjustments[1]
(Percent)

	Jan-22	Jul-22	Dec-22	2022 Jan-Dec	Jan-23	Apr-23	2023 Jan-Jun
Natural Gas							
Households	30	30	0	**69**	0	3	**-10**
Corporations	36-46	81	0	**157**	0	12	**-1**
Electricity							
Households	30	0	68	**116**	-39	-9	**-56**
Corporations	40	0	133	**227**	-44	-6	**-58**

Source: San Marino Regulatory Authority for Public Services; and IMF staff estimates.
1/ Referes to the energy component of overall tariffs.
Grey shaded areas represent indexed tariffs.

- ***Electricity***: Despite the cost-hedging during 2022, the main tariff adjustments were delayed until late 2022. By late 2022, global electricity prices started to decline. Therefore, in December 2022, the authorities increased and indexed tariffs to the Italian wholesale electricity price plus a spread to ensure profits in AASS. Overall, tariffs for households increased about 68 percent in December 2022 and afterwards have declined 56 percent in first half of 2023.

- ***Gas***: In 2022, tariffs increased about 69 and 157 percent for households and firms respectively. A favorable contract for natural gas supply mitigated the higher costs of natural gas. But with the decline in global natural gas prices in 2023, the authorities exited the contract in February 2023 and in April 2023 tariffs were indexed to the Italian wholesale natural gas price plus a spread, as was done for electricity.

While the new tariffs ensure AASS sustainability, there were implementation challenges. In February 2023, the government determined a temporary reduction in the spread factor of electricity tariffs during 2023Q1 to smooth the transition to the new system, but the spread was fully restored in April 2023. Also, operational issues on invoicing of natural gas created delays in collections in 2023Q1.

[1] See Country Report No. 2022/349.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

October 31, 2023

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared by European Department

CONTENTS

FUND RELATIONS

(As of August 31, 2023)

Membership Status: Joined September 23, 1992; Article VIII

General Resources Account	**SDR Million**	**Percent of Quota**
Quota	49.20	100.00
Fund holdings of currency	49.20	100.00
Reserves tranche position	0.00	0.00

SDR Department	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	62.69	100.00
Holdings	47.66	76.03

Outstanding Purchases and Loans
None

Latest Financial Arrangements
None

Projected Obligations to Fund 1/
(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2023	**2024**	**2025**	**2026**	**2027**
Principal					
Charges/Interest	0.15	0.61	0.61	0.61	0.61
Total	0.15	0.61	0.61	0.61	0.61

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangements:
The *de jure* and *de facto* exchange rate arrangements in San Marino are classified as no separate legal tender. Prior to 1999, the currency of San Marino was the Italian lira. Since January 1, 1999, San Marino uses the euro as its official currency. Foreign exchange transactions are conducted through commercial banks without restriction at rates quoted in Italian markets. There are no taxes or subsidies on purchases or sales of foreign exchange. San Marino has accepted the obligations under Article VIII, Section 2(a), 3, and 4 of the IMF's Articles of Agreement, and maintains an exchange system free of multiple currency practices and restrictions on the making of payments and transfers for current international transactions, except for those maintained solely for the preservation of

national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).[1]

Latest Article IV Consultation:
San Marino is on a 12-month cycle. The previous Article IV consultation discussions took place during September 27–October 7, 2022, and the consultation was concluded on November 1, 2022 (IMF Country Report No. 22/349).

FSAP Participation:
A review under the Financial Sector Assessment Program (FSAP) was completed in 2010.

Technical Assistance:

Year	Department/Purpose
1997	STA Multi-sector assistance
2004	STA Monetary and financial statistics
2005	MFD Deposit insurance
2008	STA GDDS metadata development
2009	LEG AML/CFT
2011	STA National accounts statistics
2012	STA Government finance statistics
2012	STA Monetary and Financial Statistics
2013	STA Balance of Payments Statistics
2014	FAD Expenditure Policy
2016	MCM Cassa di Risparmio Bank Restructuring
2018	FAD Foundations for a Value Added Tax
2018	FAD VAT Administrative Readiness Assessment
2018	STA Balance of Payments statistics
2019	LEG Enterprise Restructuring and Individual Over-indebtedness
2019	STA Enhanced General Data Dissemination System (E-GDDS)
2022	STA Monetary and Financial Statistics
2023	STA External Sector Statistics

Resident Representative: None

[1] EU Regulations are not directly applicable to San Marino due to Article 249 of the Treaty Establishing the European Community, but they may well be applied as a result of the legal relationship between San Marino and the EU, including the Monetary Agreement.

STATISTICAL ISSUES

(As of October 15, 2022)

Assessment of Data Adequacy for Surveillance
General: Data provision is broadly adequate for surveillance, but data gaps exist. Since posting its National Summary Data Page in January 2020, San Marino has maintained a high timeliness of data reporting. Weaknesses in the statistical database remain however, mainly due to resource constraints. National accounts as well as monetary and financial sector data are compiled according to international standards, but some key statistics (in real and fiscal sectors) are available only with delays and, in many cases, are at a lower-than-standard frequency and level of detail. Following technical assistance provided by the IMF Statistics Department, San Marino started compiling balance of payments and international investment position (IIP) in 2018.
National Accounts: National accounts data for 2007 onward have been calculated in accordance with ESA95, and data are compiled annually based on production and expenditure approach, albeit with about 10 months delay. Methodological improvements starting 2015 lead to historical series revision. Employment data are available monthly. An industrial production index based on electricity consumption, launched in 2000, became available monthly in 2009 but it is updated irregularly. A purchasing managers' index has been compiled starting in 2010.
Price Statistics: Consumer prices data are available monthly.
Government Finance Statistics: The authorities have provided data for the central government, state-owned enterprises, and social security fund for 2004–20, and preliminary data for 2021. However, data have not been compiled in accordance with IMF standards. Financing items, such as amortization, are included as expenditures while "financing needs" are included among revenues. The authorities report annually fiscal data in the GFS Yearbook, revenues, expenses and stock of assets and liabilities for the General Government in the format of the GFSM2014, the last year reported is 2019.
Monetary and Financial Statistics: In 2018, the Central Bank of San Marino began using the standardized Report Forms to submit Monetary and Financial Statistics to the Fund for use in surveillance and for dissemination in *International Financial Statistics*. Data for Other Financial Corporations are not available. There is a need for improving the classification of commercial bank assets/liabilities.
Financial Sector Surveillance: The authorities' reporting of financial soundness indicators (FSIs) has been revised in Sep-2022. Twelve out of seventeen core for deposit takers are disseminated on a quarterly basis. FSIs for other financial corporations, nonfinancial corporations, and households are not reported. The authorities should shift to a timelier provision of quarterly FSI data to the Fund with a time lag of no more than four months.
External Sector Statistics: In 2018, San Marino started compiling balance of payments and IIP. Frequency, coverage and reporting should be improved. Data are reported once a year and with a long lag. In addition, there are several data gaps in the balance of payments, IIP, and external debt components. Going forward, the authorities should sustain efforts to improve the frequency, coverage, and reporting of relevant statistics.

San Marino: Common Indicators Required for Surveillance
(As of Oct. 5, 2023)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Sept 2023	Sept 2023	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jul 2023	Sept 2023	M	M	M
Reserve/Base Money	Jul 2023	Sept 2022	M	M	M
Broad Money	Jul 2023	Sept 2022	M	M	M
Central Bank Balance Sheet	Jul 2023	Sept 2022	M	M	M
Consolidated Balance Sheet of the Banking System	Jul 2023	Sept 202	M	M	M
Interest Rates[2]	Jun 2023	Sept 2023	M	M	M
Consumer Price Index	June 2023	Sept 2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2021	Sept 2023	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	2021	Sept 2023	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2021	Sept 2023	A	A	A
External Current Account Balance	2021	May 2023	A	A	A
Exports and Imports of Goods and Services	Jun 2023	Sept 2023	M	M	M
GDP/GNP	2021	Sept 2023	A	A	A
Gross External Debt	2021	Sept 2023	A	A	A
International Investment Position[6]	2021	Sept 2023	A	A	A

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Deposit and lending rates.

[3] Foreign, domestic banks, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Statement by Messrs. Giammusso and Cocozza on San Marino
November 17, 2023

The authorities of the Republic of San Marino express their appreciation for the cooperative discussions held with Fund staff during the Article IV consultation. They broadly concur with the staff's analysis and will continue to rely on the Fund's recommendations to strengthen economic growth, safeguard financial stability and maintain sound public finances. The authorities welcome the staff's recognition that their policy efforts have been instrumental to boosting long-term growth perspectives and increasing the resilience of the economy to shocks.

The economic perspectives for the Republic of San Marino have changed greatly over the past 10 years. Following the remarkable crisis of the 2008-14, when financial sector lost 80 percent and nonfinancial sector lost 15 percent of the value added, the financial sector has entered a deep crisis, from which it is gradually recovering, while the nonfinancial sector has experienced a recovery driven by labor cost-competitiveness and strong balance sheets. Together with prudent fiscal policy and access to international market, the robust performance of the nonfinancial sector has been key to mitigate the impact of the pandemic and Russia's invasion of Ukraine. Real GDP growth hit 14.2 percent in 2021, is estimated at 5.0 percent in 2022 and is projected at 2.2 percent this year. The authorities are aware that these important milestones are only a first step in ensuring a stable and lasting growth path. They are committed to continuing with prudent fiscal policy, restructuring of the financial sector and further liberalizing the labor market to increase competitiveness. San Marino's economy will largely benefit from the Association Agreement with the European Union: and the authorities are optimistic that the agreement can be finalized by 2023 and approved next year.

For the most recent period, and as in the rest of European countries, rising inflation has eroded real incomes. However, increases in gas and electricity tariffs have been well below those experienced by other countries. As acknowledged in the staff report, this was due to a timely long-term gas contract and appropriate hedging operations for electricity by the state-owned utility company (AASS). Inflation is largely imported, mainly from Italy's food prices; however, second round effects have been moderate as wages increases were limited by prudent collective wage agreements. Output growth has been reflected in the labor market, which continues to be close to full employment: the unemployment rate (3.5 percent according to the latest data) reflects the structural component.

The authorities broadly agree with the staff's assessment of the outlook and risks. The impact of inflation and higher interest rates could negatively affect the economy's growth rate; on the other hand, employment may not decline, partly as a result of moderate wage trends and difficulties in finding skilled labor. The authorities underscore that the resilience of the economy demonstrated in recent years has also been due to prudent fiscal and wage policies. They are committed to ensuring the strengthening of these policies in the future.

Fiscal Policy

Since 2021, San Marino has strengthened its fiscal position through prudent use of revenue windfalls and careful spending. In 2022, the primary balance net of bank support improved by 5 percent of GDP; the structural balance by 1 percent. These are trends that will continue in the current year. Since the authorities are aware that fiscal policy is the only instrument of macroeconomic stabilization, they have managed to improve the fiscal position and they are committed to strengthening the ongoing consolidation process. The staff's suggested target of public debt below 60 percent of GDP, which would be consistent with the European framework, to be achieved by 2028, is considered reasonable and achievable. To this end, the introduction of VAT is seen as inevitable in the context of greater integration with the EU, and the authorities agree on the need to proceed with strengthening public financial management and spending efficiency also for extra-budgetary agencies.

As acknowledged by the staff, a decisive step forward in consolidating public finances was achieved with the 2022 pension reform. The measure reduced the pension deficit and the related depletion of pension fund assets over the next 10 years through an increase in contribution rates, retirement age, and the link between contributions and benefits. Authorities are aware, however, that post-2035 sustainability is not yet assured and further action will also be needed to meet the challenges due to an aging population.

Given the importance of fiscal policy for San Marino's economy, a medium-term fiscal framework could lead to broad benefits both for macroeconomic stabilization and for the country's credibility on the path to further international integration. The authorities are aware of the need for medium-term scenarios for fiscal policies to assess debt sustainability dynamics. The medium-term orientation will have to be consistent with a public debt management strategy aimed at safeguarding adequate levels of liquidity in a context of minimizing borrowing costs.

Financial Sector

Despite the growth of the economy, local banks in recent years struggled to increase the supply of credit, as they continued to focus on reducing NPLs, which remain at a high level (54.6 percent of gross loans; 26.7 percent net of provisions). The authorities are aware that the banking system continues to pose a key challenge to the country's economic prospects, despite the progress made in recent years to foster restructuring and consolidation in the sector.

In recent months there has been significant progress, as also recognized in the staff report, regarding the strategy for reducing NPLs through an Asset Management Company (AMC) and calendar provisioning. Reputable arranger, servicers, and rating agency with international experience have been appointed. Once the valuation of NPLs has been completed, the senior tranches of AMC securities, which have a government guarantee, will be placed in the international market while the mezzanine and junior tranches will go back to the bank's balance sheets. The international placement of the senior tranche will provide liquidity to the banks while the NLPs remaining on banks books will be subject to calendar provisioning. The authorities are confident that the securitization scheme, together with the calendar provisioning, will be key to durably reduce NPLs, besides, potential capital need that might emerge in the securitization process will be addressed proactively, also by removing legal limit on banks ownership structure.

The authorities are satisfied with the progress made so far in restructuring the banking system, especially in the recovered levels of profitability, liquidity and current capital adequacy, but at the same time are aware that it is not a finished journey. In this context, they agree that the next challenges are related to the efficiency of the system with a focus on the reduction of the territorial network, redundant staff, and the wage bill. On the asset side, they do not underestimate the importance of increasing income-producing activities at the expense of non-profitable ones. The Sammarinese authorities will meet these challenges with the same determination they have shown in recent years with the goal of bringing the banking sector up to the levels of profitability and integrity of other European countries.

The independence of the central bank and its ability to operate as a lender of last resort are important elements of a healthy financial system that can adequately allocate savings to the most productive uses. From this perspective, the staff rightly warns that the financial consequences of the Association Agreement with the EU, with the adoption of the European financial sector framework, could be significant. San Marino authorities are prepared to bear the costs related to compliance.

Structural reforms

Progress in making the labor market more flexible, particularly related to the 2017 and 2021 measures, has strengthened the competitiveness of the manufacturing sector and has been important in ensuring favorable labor market conditions. Additional steps forward were also made in 2022 regarding temporary contracts and the extension of fixed-term contracts up to 24 months. Further measures, such as those related to restrictions during high unemployment on cross-border hiring and the operation of temporary employment agencies, are currently being considered by the authorities, who are committed to resolving additional obstacles that may undermine the intended flexibility.

The energy tariff system has worked well in limiting the effects of rising prices on households and businesses. Given the uncertainty about the evolution of future prices and the needs of the green energy transition, the authorities are finalizing a system that allows, on the one hand, a broader attention to the signaling role of prices, which therefore favors energy savings and the reduction of climate-altering emissions, and on the other hand, adequate support for the most vulnerable groups.

As recognized by the staff, the data provided with the IMF's Enhanced General Data Dissemination System is broadly adequate for surveillance. This notwithstanding, there is a need for improving the quality and the frequency of the statistics. The authorities are grateful to the staff of the IMF for their advice on this front, and are thinking about how to ensure a better supply and dissemination of statistics on the economy of San Marino, also in view of the upcoming international integration agreements.

The Sammarinese authorities have long been discussing the Association Agreement with the European Commission. The negotiation is at an advanced stage and the authorities expect it to be concluded by the end of the year, with the signing in 2024. This would be a historic milestone with positive spillovers on growth and macroeconomic stability. On the eve of such an important step, the authorities wish to thank the staff of the International Monetary Fund for their recommendations on how to proceed with the modernization of the economy.