March 2011
IMF Country Report No. 11/78

Republic of San Marino: 2010 Article IV Consultation—Staff Report; Supplement to the Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for 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 2010 Article IV consultation with San Marino, the following documents have been released and are included in this package:

- The staff report for the 2010 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on**,** January, 14 2011, with the officials of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 24, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- A supplement of February 24, 2011 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 14, 2011 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for San Marino.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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REPUPLIC OF SAN MARINO

Staff Report for the 2010 Article IV Consultation

Prepared by the Staff Representatives for the 2010 Article IV Consultation with San Marino

Approved by Adam Bennett and Thomas Dorsey

February 24, 2011

Overview: After a long recession, the economy is struggling to recover. The financial sector is adjusting to the effects of Italy's tax amnesty, and to the resulting decline in the size of banks' balance sheets. A long period of fiscal surpluses has ended, due to the cyclical downturn and lower revenues from the financial sector. The authorities have strengthened financial regulation, diluted bank secrecy, and tightened anti money-laundering defenses. The key challenges facing San Marino are the need to (i) shore up the financial position of the largest bank and develop a sustainable new business model for the financial sector; (ii) embark on more comprehensive reforms to secure an effective medium-term fiscal consolidation strategy; and (iii) enhance the economy's flexibility to buttress an eroding competitiveness position.

The 2010 Article IV discussions were held in San Marino during January 4–14, 2011. The team comprised of Mr. Epstein (head), Mr. Jeasakul and Ms. Zoli (all EUR), and Mr. Pratt (consultant).

The mission met with Finance Minister Valentini, Central Bank Governor Clarizia, other senior government officials, and private sector representatives including from the employers' associations and the banking association.

The mission's concluding statement was published on January 14, 2011 and can be found at: http://www.imf.org/external/np/ms/2011/011411.htm.

Past surveillance: During the 2009 Article IV Consultation, Directors noted San Marino's macro-financial vulnerabilities. Directors urged the authorities to implement the FSAP recommendations to further reinforce financial sector supervision and encouraged them to address the lack of an effective lender-of-last resort framework. Directors considered the fiscal policy stance to be broadly appropriate. At the same time, they emphasized the importance of ensuring fiscal sustainability. Directors underscored the need for greater product and labor market flexibility.

Contents Pages

I. Context

1. **The tax haven model – intensifying pressure to change**. For years, the Sammarinese economy benefited from its tax haven and bank secrecy status. Banks were able to attract substantial deposits from abroad, helping to propel system assets to around 900 percent of GDP by end-2008, while boosting income and employment growth. However, under pressure from larger economies, tax havens around the world have been forced to embrace greater transparency. In this context, San Marino is currently undergoing a strategic review of its business model and has made some progress on enhancing financial transparency. Italy has added to the pressure by increasing its crackdown on tax havens. It launched a tax amnesty in September 2009 and, in July 2010, extended the impact of an earlier inclusion of San Marino on a 'blacklist' of tax haven countries, further straining relations between the two countries.[1]

2. **A fragile economic setting.** The economy is struggling to recover from a long recession. The financial sector is still adjusting to the effects of Italy's tax amnesty, which led to a significant outflow in bank deposits and, consequently, to a considerable decline in the size of Sammarinese banks' balances sheets. The system has shown some resilience to the deposit outflow, but liquidity, profitability and asset quality have also been affected by the economic slowdown. The central bank of San Marino (CBSM) has been monitoring and responding to the effects of the tax amnesty and other developments, including the international pressure for greater economic and financial transparency and the resolution of Italy's troubled Delta Group, which is owned by Cassa di Risparmio di San Marino (CRSM), San Marino's largest bank. Certain other sectors, e.g., manufacturing, have begun to gradually recover from the spillovers of the global financial crisis, but overall investment remains dormant, as confidence is low and uncertainty looms large.

II. Recent Economic Developments and Outlook

3. **A long recession may end this year.** Following two years of economic contraction—1 percent in 2008 and 13 percent in 2009—led primarily by a 37 percent decline in fixed investment (Figure 1), the Sammarinese economy remains weak, with construction activity and employment in the manufacturing sector well below their levels in the period preceding the global financial crisis. Notwithstanding a moderate expansion in manufacturing and commercial activity during the first half of last year, rising unemployment, stagnant wage growth, and lower confidence have all contributed to a fall in consumption. As a result, real GDP is estimated to have declined by about 1 percent in 2010, while recent activity indicators

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[1] The tax amnesty was in effect through April 2010 and led to a fall in bank deposits by more than a third. Since July, Italian firms doing business with Sammarinese companies are subject to enhanced scrutiny from the Italian authorities and are more likely to be inspected. As a result of increased burdensome, a number of Sammarinese companies have since moved their operations to Italy.

suggest that the economy has been slow to recover (Figure 2).[2] This year, the economy could build some momentum, subject to normalization of relations with Italy, which accounts for 90 percent of San Marino's exports (Figure 3), but growth is projected to be meager below 1 percent (Table 1).

4. **Employment declined steadily over the past two years, but a generous wage-supplemental system has kept the unemployment rate contained.** Following strong employment growth during the pre-crisis period, the unemployment rate has risen from a low of 2.4 percent in mid-2008 to a high of 5.6 percent in late-2009. The unemployment rate fell steadily during the first half of last year, but has since increased again to 5.3 percent (November). While the unemployment rate more than doubled since 2008, the upward move was relatively modest, considering the sharp decline in output. This is largely explained by a substantial increase in the usage of the wage-supplemental system over the past two years (Figure 4).[3] At the same time, the output collapse in 2009 translated into a sharp deterioration in productivity and a significant increase in unit labor costs, as average wage and overall labor cost remained roughly unchanged from a year earlier.

5. **The financial sector is still adjusting, in the wake of the tax amnesty.** The banking system was able to withstand a 35 percent deposit outflow in 2009-10, largely because of the previous substantial holdings of (mainly foreign) liquid assets. A large portion of these assets were sold to manage the deposit outflow. Balance sheets have shrunk accordingly and become less liquid (see Box 1, Table 2 and Table 3). Because of the economic slowdown, asset quality declined too. Nonperforming loans (NPLs) rose from about 4 percent of total loans at end-2008 to an estimated 10 percent in June-2010, while system profitability fell significantly over the same period. In view of the weak economic outlook, NPLs are expected to continue to increase in the near term, further squeezing banks' profits.

6. **Risks to the outlook are mainly on the downside.** Given a moderate growth outlook for Italy, output expansion is projected to remain weak over the medium term. Moreover, financial sector profitability and employment are likely to be lower than in recent years, because of the compression in banks' balance sheets, following the tax amnesty, as well as the need to adjust to new regulations and develop a new business model. In this context, staff projects output growth of 0.8 percent and 1.1 percent in 2011-12, compared with an average growth rate of about 3.5 percent in the pre-crisis period and over 7 percent during the 1990s. The central scenario assumes a normalization of relations with Italy. Risks to this scenario are

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[2] National account data are only available annually, and with a long lag; thus, staff's near-term projections primarily rely on a new monthly economic activity indicator, constructed by staff, which comprised of high frequency indicators of manufacturing, retail, tourism, and financial services.

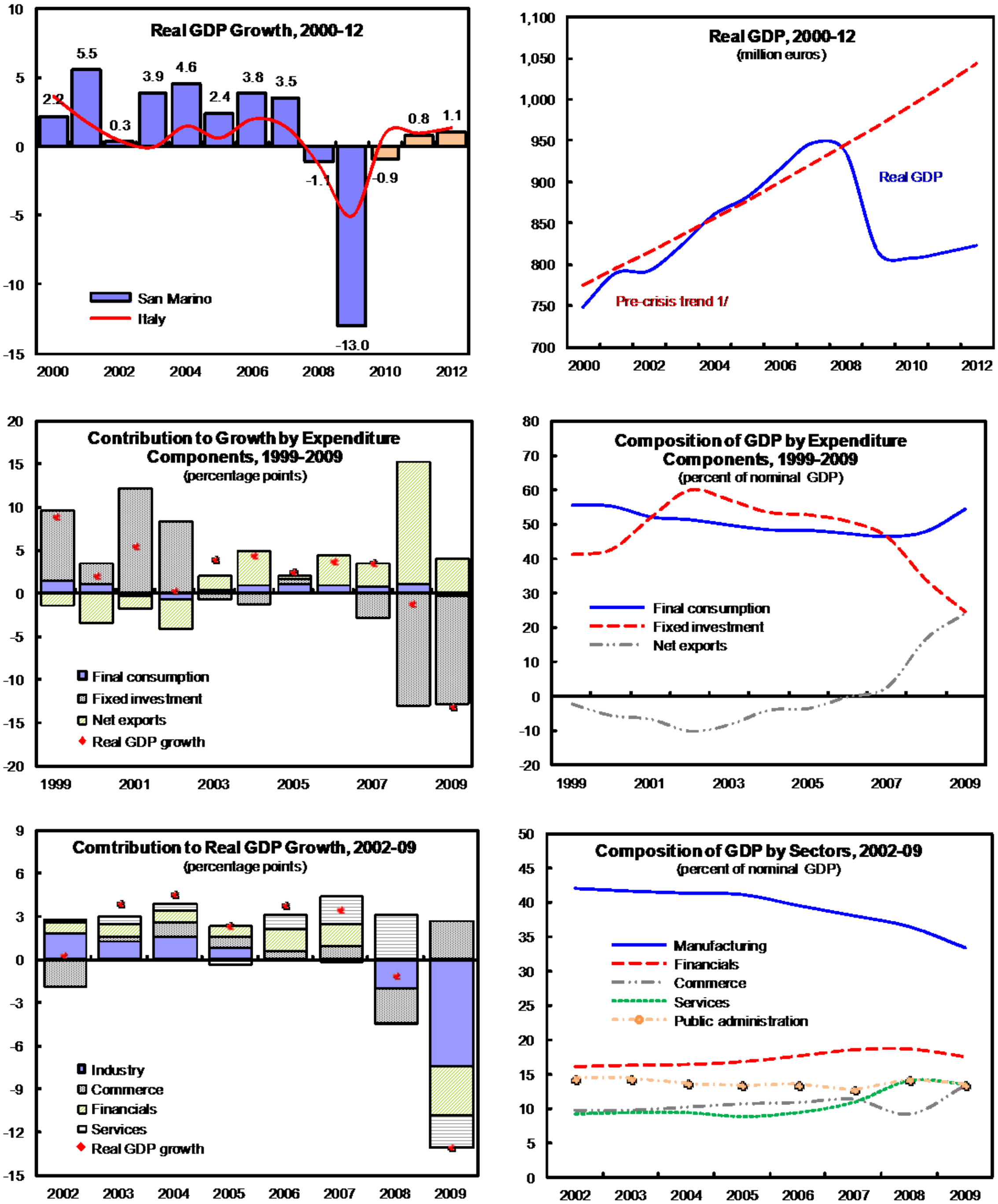
[3] This government subsidy program essentially allows firms to continue to operate in an environment of rapidly falling demand without the need to either lay off employees or cut down on their salaries.

tilted to the downside, not least because of the uncertainty surrounding San Marino's strained relations with Italy.

Authorities' views

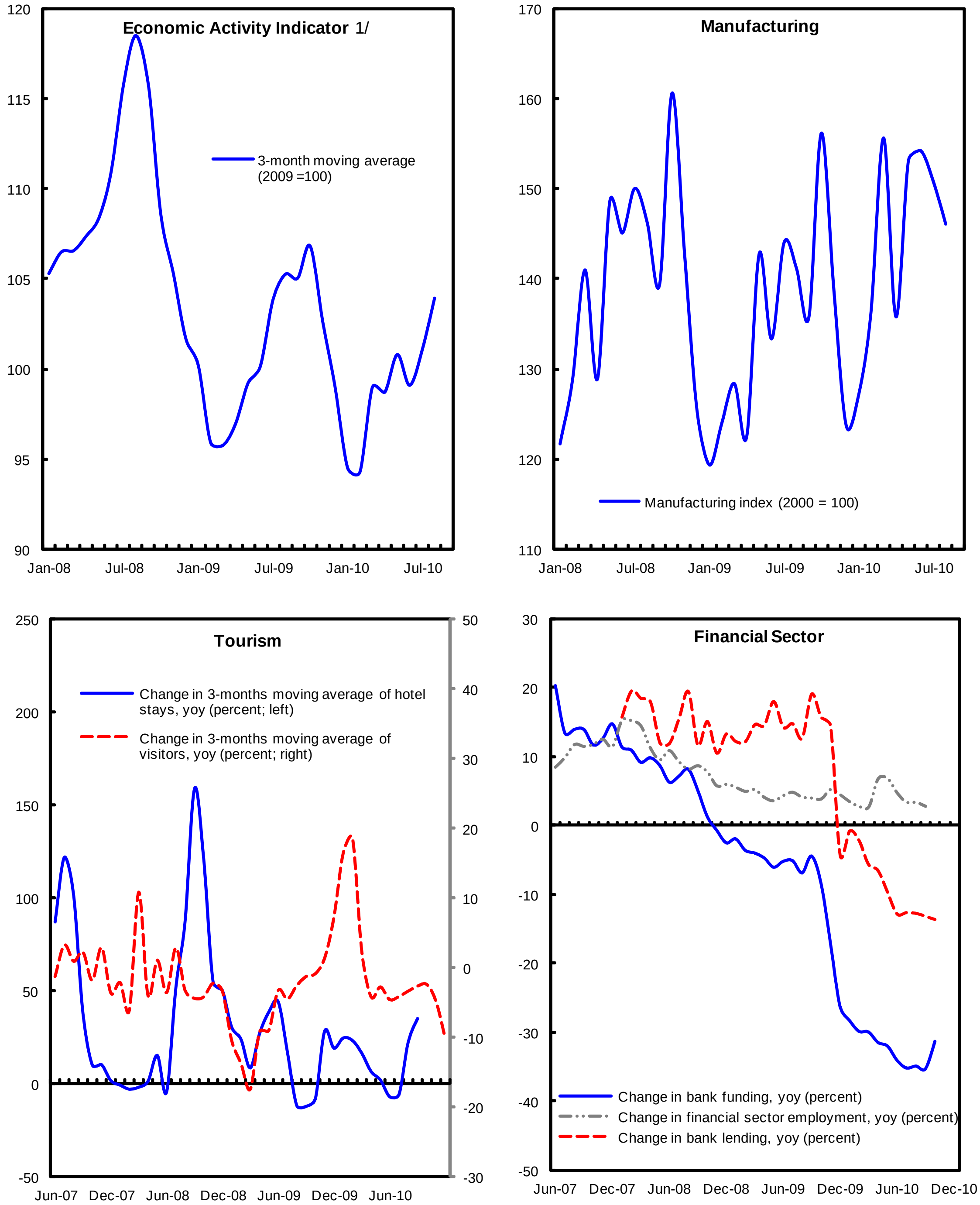
7. **The authorities concurred with staff's views about the economic outlook**. The government does not produce standard macroeconomic projections. However, the authorities agreed with the staff on its assessment of current macroeconomic conditions and shared staff's view on the downside risks to the medium-term outlook. In particular, the authorities highlighted the strained relations with Italy as the primary downside risk to the outlook.

Figure 1. San Marino: Output Developments, 1999-2012



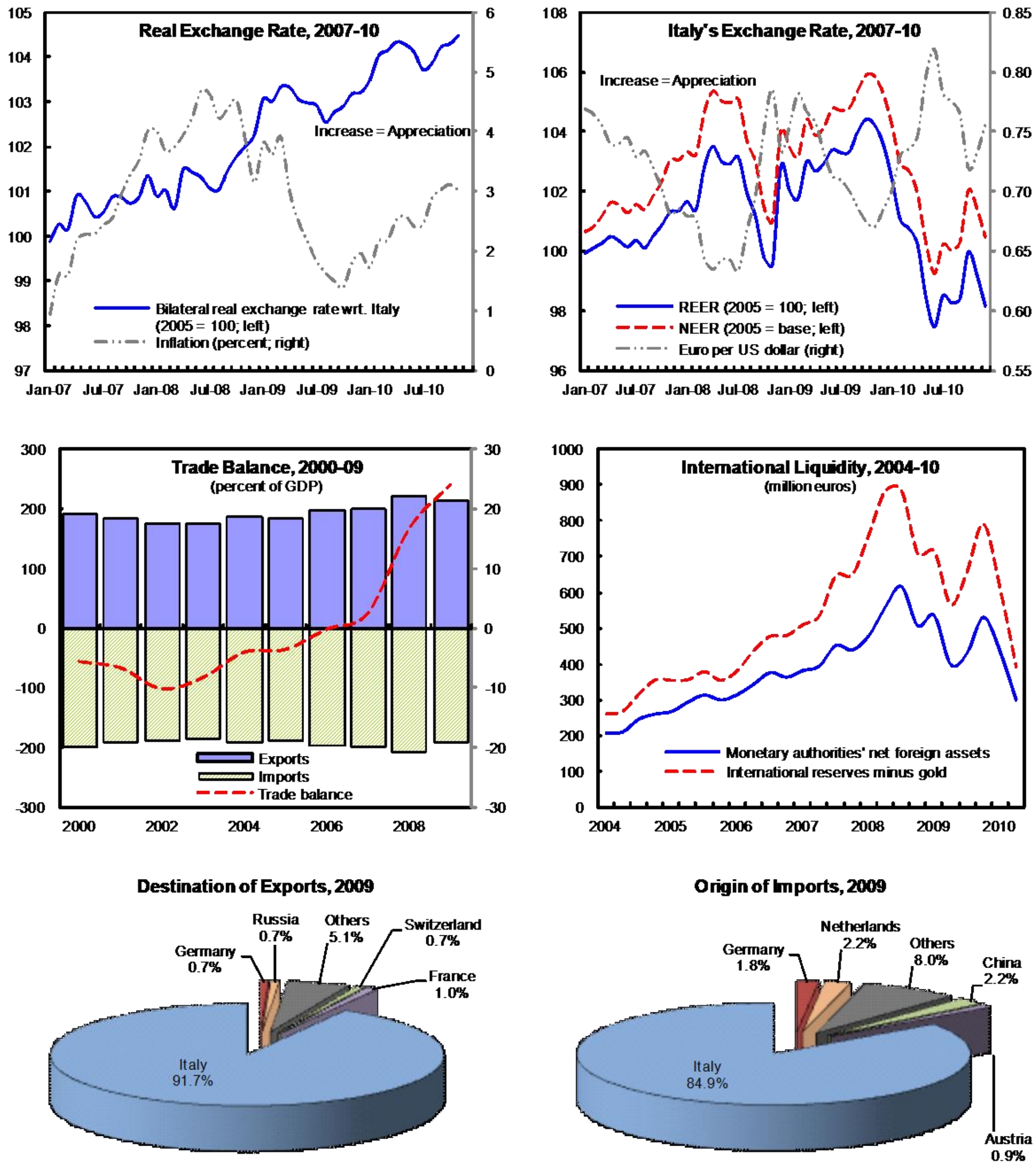
Sources: IMF, World Economic Outlook, Sammarinese authorities; United Nations; UPECEDS; and IMF staff calculations and projections.
Note: Lines are smoothed between actual data points.
1/ The trend is constructed based on the average growth rate over 2000-2008.

Figure 2. San Marino: Recent Economic Activity Indicators, 2007-2010



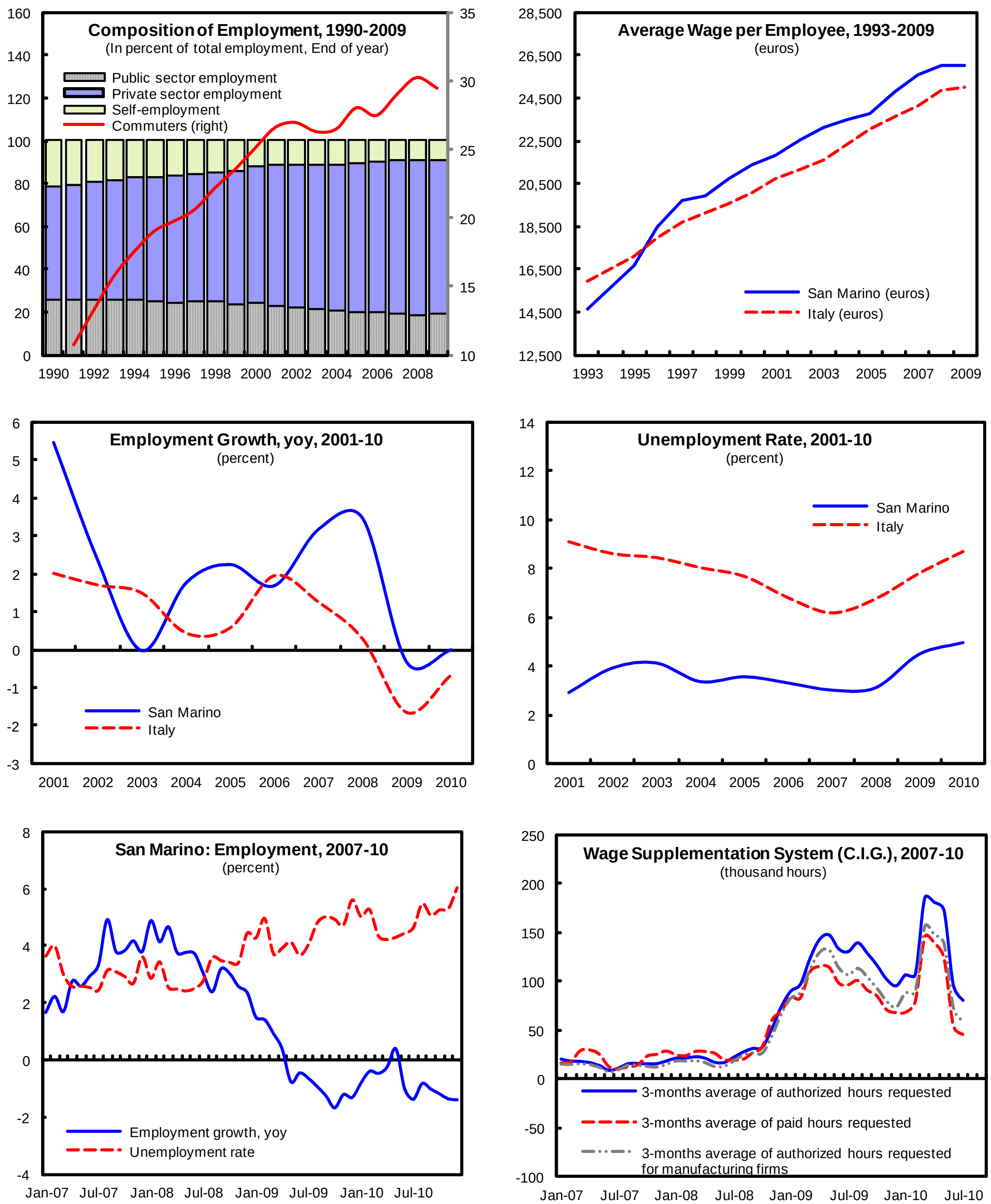
Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations and estimates.
Note: Lines are smoothed between actual data points.
1/ Constructed based on activity indicators for commerce, construction, financials, and manufacturing, weighted by each sector's contribution to GDP.

Figure 3. San Marino: External Sector Indicators, 2000-2010



Sources: CBSM; IMF', Information Notice Systeml and International Financial Statistics; UPECEDS; and IMF staff calculations.
Note: Lines are smoothed between actual data points.

Figure 4. San Marino: Labor Market Developments, 1990-2010



Sources: IMF, World Economic Outlook; ISTAT; UPECEDS; and IMF staff calculations.
Note: Lines are smoothed between actual data points.

Box 1. San Marino's Financial System in the Aftermath of Italy's Tax Amnesty

The tax amnesty, which was in effect between September 2009 and April 2010, took a severe toll on San Marino's financial sector. Bank deposits fell by 35 percent, while assets managed by financial companies dropped over half. The tax amnesty did not result in reducing the number Sammarinese banks, but quite a few non-bank financial institutions were forced to close down.

In light of the weak economy, profitability and asset quality have also been affected over the past year. Banking system profits were €47.3 million at end-2008 and €47.2 million at the end of 2009. By mid-2010, system profits dwindled to €13.2 million, while the CBSM estimates that profitability continued to fall since then. Asset quality declined too, with NPLs (including problem and doubtful loans) rising from about 4 percent of total loans at end-2008 to an estimated 10 percent at mid-2010.

Still, the banking system successfully withstood the sizable deposit outflows, in large part due to the nature of its old business model. Deposit rates offered by Sammarinese banks prior to the amnesty did not need to be particularly competitive, as it was confidentiality rather than the rate of return that attracted Italian deposits. Given that the cost of funds was relatively modest, Sammarinese banks could afford to invest substantial funds in relatively liquid securities with lower returns. These holdings of liquid securities were strength to the system when the banks had to manage the effects of the tax amnesty. By the middle of 2010, the extent of liquid resources was significantly reduced. Moreover, whereas previous tax amnesties only resulted in a temporary fall in deposits, the most recent amnesty is expected to reduce the deposit base permanently, as it coincides with the dilution of bank secrecy and the transformation of the business model.

Financial System
(millions of euros)

	Dec-08	Dec-09	Jun-10
Number of banks	12	12	12
Number of financial companies	53	49	37
Assets of banks	11,536	9,447	8,570
Fiduciary activity by financial companies	3,460	1,921	1,496

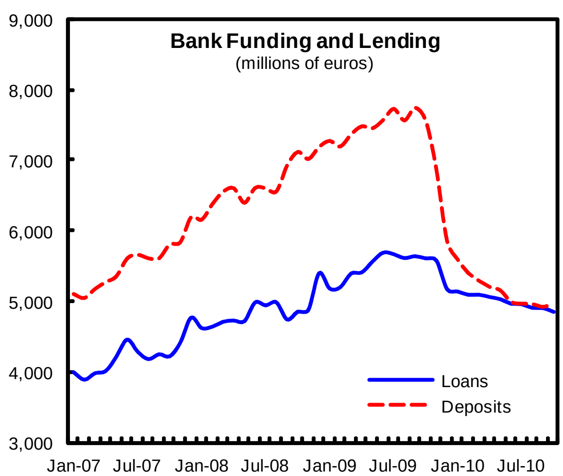
Banking System Deposits
(millions of euros)

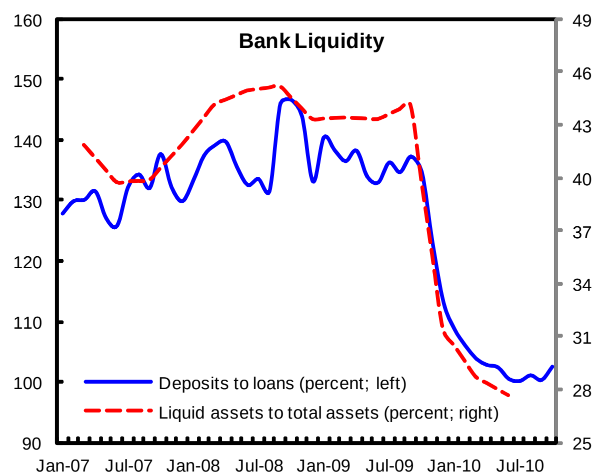
	Dec-08	Dec-09	Jun-10
Total deposits	7,182	5,843	4,985
of which: by nonresidents	4,180	3,038	2,554

Banking System Assets
(millions of euros)

	Dec-08	Dec-09	Jun-10
Cash	45	43	30
Loans to banks	1,251	1,206	1,322
Bonds and other debt securities	3,917	2,312	1,647
Loans to customers	5,129	4,887	4,642
Fixed assets	199	185	182
Other assets	994	814	747
Total assets	11,536	9,447	8,570

Sources: CBSM; IMF, International Financial Statistics; and IMF staff calculations and estimates.





Source: CBSM; IMF, International Financial Statistics; and IMF staff calculations.

III. Policy Discussions

A. Financial Sector

8. **In the wake of rising system vulnerabilities, the central bank has taken measures to bolster liquidity.** Following on the 2009 stepped-up liquidity reporting requirements, which were aimed at monitoring the effects of the tax amnesty, the central bank last year implemented a new reserve requirement system that helped spur the development of a domestic interbank lending market.[4] In addition, the CBSM has proposed to implement a new arrangement whereby securities held by Sammarinese banks could be pooled and used by the CBSM as collateral for repo agreements with foreign counterparties, thereby obtaining added liquidity. The CBSM is further considering (i) new rules that would permit the securitization of bank loans, (ii) taking on a role in managing the supply and distribution of cash to banks, so as to increase efficiency, and (iii) introducing a central register of credit risks so as to ensure it is aware of the exposure of the banking system to single or connected borrowers. Some of these measures would require close cooperation with the Italian authorities.

9. **A recapitalization plan is being considered in order to buttress the financial position of CRSM.** The assets of CRSM account for close to 40 percent of the banking system and are the equivalent of about 300 percent of San Marino's GDP. The resolution of Italy's Delta Group, which is largely owned by CRSM and has been under special administration since mid-2009, may result in sizable losses to CRSM. Based on preliminary information, staff estimates that net losses from the Delta resolution to CRSM could result in recapitalization needs of about €160 million.[5] However, losses from Delta could be higher, which would entail larger recapitalization needs.[6] A final assessment of the scale of Delta's losses is expected by end-March, although the final agreement with creditors and shareholders may not happen until June. The Central Bank is monitoring the resolution process and evaluating various contingency options.

10. **Progress has been made on meeting the 2009 FSAP recommendations.** The authorities secured passage of important legislation to buttress financial sector supervision. They have taken measures to enhance the independence and resources of the CBSM, fortify on-site and off-site supervisory functions, and enable the CBSM to assist in the provision of liquidity to banks. In addition, new regulations have circumscribed the activity of fiduciary

[4] A reserve requirement ratio was initially set at 8 percent, which is waived proportionally for Sammarinese banks that lend to each other, hence encouraging an interbank market that did not exist before 2010.

[5] Under such scenario, a recapitalization plan has been devised which would shore up CRSM's regulatory risk weighted capital ratio back above the 11 percent minimum required by the CBSM.

[6] In that event, an alternative could be to allow CRSM a transitional period, during which the bank would be permitted to operate with capital below the minimum, provided that it either raise further capital over a set timetable or find a reputable buyer.

companies, enhanced AML/CFT defenses, abolished the use of bearer shares, and tightened customer due diligence requirement (see Box 2). However, while supervision has been conducted by the strengthened supervisory staff under the direction of the Supervision Committee of the CBSM (Chaired by the Director General), the position of the Head of Supervision has remained vacant for over a year.[7]

11. **The business model that sustained the rapid expansion of banks' balance sheets is no longer viable.** This has profound long-term implications for the Sammarinese financial sector. The scale of the deposit outflow that resulted from the tax amnesty gives an indication of the motivation of much of the Italian business handled by Sammarinese financial institutions. The CBSM fully understands that there could be no return to a business model based on bank secrecy and tax haven status. Indeed, the measures already taken to tighten regulations and increase transparency ruled this out.

12. **The authorities and the private sector are undertaking a strategic review of the financial system's prospects.** Emerging ideas envisage the development of fee-based services (such as specialist asset management) that (i) do not rely on bank secrecy, (ii) provide genuine value added, and (iii) should not result in the expansion of banks' balance sheets beyond the capacity of the limited lender of last resort (LOLR) facilities of the CBSM. Indeed, the CBSM's capacity to act as a LOLR, particularly to domestically owned banks, is limited by its inability to create money, leaving liquidity pressures very difficult to manage. New financial activity within San Marino would be limited at first, perhaps confined to the administration of collective investment schemes, with portfolio management and depositary services initially outsourced. In time, however, and coinciding with the development of relevant new skills, San Marino may be able to increase the local value added of such services.[8] In addition, strengthening relationships with reputable foreign banks, including through acquisition by foreign banking groups, would enable Sammarinese banks access to a LOLR with full powers.[9]

13. **The new business model may involve mergers of banks, including with foreign participation, but normalizing relations with Italy is a key prerequisite.** The CBSM is in favor of mergers and the Parliament had enacted a law to facilitate this. Mergers with foreign

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[7] In early 2010, the authorities dismissed the Head of Supervision, prompting the resignation of the Governor and Director General because the dismissal undermined CBSM independence. Although the posts of Governor and Director General have now been filled, there is as yet no Head of Supervision.

[8] See accompanying *Selected Issues* Paper entitled: "The Development of a New Business Model for San Marino's Financial Sector"

[9] The acquisition by foreign banks may need to be accompanied by appropriate arrangements with the foreign country authorities, so as to ensure that LOLR can be given at certain conditions also to the Sammarinese entities, even if they are not deemed systemically significant by the foreign country.

banks, while advantageous, would face obstacles, unless relations with Italy improve. Indeed, the main barrier to the development of a new business model and any consolidation of the financial system involving foreign participation is the state of relations with Italy. Currently it is not possible for Italian banks to invest in or acquire Sammarinese financial institutions until an appropriate bilateral agreement is in force. A financial cooperation agreement has been signed, but will not take effect until a double taxation treaty is also signed by the two countries. Moreover, Italy's designation of San Marino as a tax haven will likely frustrate Sammarinese attempts to develop new, legitimate business lines with Italian entities.

Authorities' views

14. **The authorities acknowledged the challenges in developing an alternative business model under current circumstances.** In particular, they recognize that San Marino was starting late in developing new skills and that there are a number of competitors which are well ahead of them. Nonetheless, the authorities argued that the financial sector could develop a modest asset management business, beginning with products sold to institutional investors, and that they had already established a committee comprising of the government, central bank, and private sector to consider strategic alternatives.

15. **The CBSM recognized that the legacy of the past was inevitably affecting Italy's position and that it would take time to reestablish a reputation.** The authorities had demonstrated their good intentions by introducing tighter regulation and stronger AML/CFT defenses and had responded rapidly to the FSAP recommendations. In the meantime, San Marino remains relatively isolated and efforts to seek financial agreements or investments beyond Italy were frustrated by the inevitable suspicion of interlocutors of the inability of San Marino to conclude agreements with its most obvious partner. The CBSM accepted the need to develop its reputation over time but pointed out that it may need to take more immediate steps, including with respect to the provision of additional liquidity to the banking system.

Box 2. Actions taken to meet the 2009 FSAP recommendations

The authorities have taken action to address the FSAP recommendations, a detailed discussion of which is presented in Appendix I. In particular, the authorities:

1. **Took measures to enable the CBSM to assist in the provision of liquidity to banks**, through the implementation of a reserve requirement system and the development of a local interbank market, and with a voluntary scheme for banks to deposit excess liquidity.
2. **Strengthened the independence and accountability of the CBSM** by:
   - Removing the role of government in placing banks under special administration and withdrawing authorization;
   - Focusing all the CBSM powers on the Governing Council, to enhance accountability;
   - Transferring the power of appointment to the Governing Council from the government to the Parliament and extending the list of posts that are regarded as being incompatible with membership of the Governing Council;
   - Strengthening the protection of the Director General (DG) by requiring unanimity of the Governing Council before the person can be dismissed and establishing limited grounds for dismissal for the DG as a member of the Supervision Committee;
   - Agreeing to a three year budget with the government, which provides some stability in budget planning for the CBSM.
3. **Amended the bank secrecy provisions in the law** with the intention of permitting subsidiary banks to pass confidential information to their parent bank.
4. **Strengthened the supervision resources of the CBSM**, enabling it to complete the on-site supervision manual, increase the number of on-site inspections and take tougher action against those who breach the regulations.
5. **Enhanced AML/CFT defenses,** by strengthening coordination with the Financial Intelligence Agency (FIA) when making on-site inspections, including through sharing risk assessments and discussing findings.
6. **Abolished bearer shares.**
7. **Issued new regulations on fiduciary companies** that require some additional due diligence on customers and specify what activities are permitted.

By addressing these measures, the authorities have demonstrated willingness to take rapid action to meet international standards. Inevitably, a number of actions still need to be taken, including:

a. **Legislative changes still leave the Government with the final say on licensing of new financial institutions,** allowing it to refuse to grant a new license, even if the CBSM considers that an applicant meets the conditions. The legislation should remove this power from the government or, at the very least, specify criteria for any government decision to reject a license and allow for an appeal.

b. **In view of the recent history, it is vital that CBSM's Governing Council is strong enough to resist pressure from political and commercial interests.** To buttress the protection against the appointment of Governing Council members with potential conflicts of interest, the authorities should publish more transparent nomination and appointment procedures. Moreover, in the event of dismissal of a member of CBSM's senior management, it is important that the authority taking the decision to dismiss should be required to give reasons to show how the decision matches the specified criteria in the law.

c. **The authorities should provide both CBSM and FIA with the additional resources** they have sought to implement the new regulatory regime effectively.

B. Fiscal Policy

17. **The fiscal position weakened significantly in 2009-10, mainly due to a sizable decline in revenues.** Tax revenues fell by close to 1 percent of GDP in 2009, and are estimated to have dropped by almost 4 percent of GDP in 2010, largely as a result of the economic slowdown and the decline in revenues from the financial sector. Consequently, the fiscal deficit is expected to have widened from 3.4 percent of GDP in 2009 to 6.1 percent of GDP in 2010 (Table 4). Government revenue, as a share of GDP, is low by international standards. For example, during 2006-09 San Marino's revenue/GDP ratio averaged about 30 percent, compared to Italy's 45 percent (Figure 5). Moreover, in order to stimulate consumption, the government last September cut the import tax rate by 2 percentage points, to 15 percent, which may undermine the overall objective of increasing revenues.[10]

18. **The authorities have taken steps to reduce the fiscal deficit.** In the three-year rolling budget approved last December, the government introduced a number of consolidation measures, including cuts in transfers to the large public sector, a reduction in the public sector wage bill, and a one-time levy on income tax payers. With these measures, the authorities expect the central government deficit to decline to about 3.1 percent of GDP in 2011. In staff's view, this projection seems to reflect rather optimistic assumptions about both the rebound in tax revenues and the containment of expenditure, especially with respect to the implementation of cuts in transfers to the rest of the public sector.[11] Consequently, the staff projects a deficit of 4.6 percent of GDP this year.

19. **There is scope to secure a more effective medium-term consolidation strategy.** While public debt is low and the economy is still weak, there is a need to secure medium term debt sustainability, given that (i) as a micro-state, San Marino lacks access to a diversified investor base, (ii) revenues are likely to be permanently depressed by the financial sector downsizing, (iii) contingent liabilities from the financial sector are potentially very high and (iv) the current pension system is unsustainable in the long term.

20. **Government debt sustainability analysis (DSA) points to a moderate upward trend in the debt profile over the medium term.** Underlying the DSA's baseline scenario, the fiscal deficit is projected to fall from 6.1 percent of GDP in 2010 to 1.7 percent of GDP in 2015. As a result of the slow decline in the deficit, public debt is projected to rise from 5.4 percent of GDP in 2010 to 10.6 percent of GDP in 2015. The baseline scenario incorporates staff's estimates of the impact of the consolidation measures introduced in the latest three-year

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[10] The import tax accounts for about 40 percent of total tax revenues. The government plans to evaluate the effectiveness of this tax cut, and, if found to be ineffective in stimulating consumption and raising revenues, may increase it back to the previous rate.

[11] Each year, the central government covers with ex-post transfers the deficit of the Social Security Institute, which is driven by the imbalance in the independent workers' pension funds. The deficit will likely persist in the next few years, even after the pension reform currently under discussion is fully implemented.

rolling budget. The baseline also reflects the following assumptions: (i) some permanent loss in revenues from the financial sector; (ii) a constant import tax rate throughout the period, at the reduced rate of 15 percent; (iii) no accumulations in governmental arrears from 2012; and (iv) half of the deficit financing occurs through a drawdown on government deposits, consistent with the financing policy mix in 2010. The debt dynamics are most sensitive to a shock to real GDP, the assumed fiscal adjustment effort, and a rise in contingent liabilities (Figure 6 and Table 5).[12]

21. **Public administration and enterprise reforms are proceeding slowly.** The government in 2009 introduced a number of laws aimed at addressing the large and bureaucratic structure of the public administration. Among other objectives, the laws envisaged greater labor mobility, enhanced autonomy and accountability for managers, and increased transparency in the hiring process. However, implementation has been slow, especially with respect to efforts to downsize and streamline the operations of public administration. At the same time, a number of reforms of state-owned enterprises were planned, but legislation has been protracted. For example, despite past considerations to adjust energy tariffs more in line with the market, subsidized utility prices have not been increased for more than a decade.

22. **Pension reforms are being pursued, but the long-term sustainability of the pension funds is not secured.** Building on the 2005 pension reforms, and in order to shore up the long-term position of the pension funds, the government plans to present to Parliament two new draft pension laws. The first law concerns the first pillar, and envisages higher contribution rates, greater harmonization in contribution rates across categories of independent workers, an increase in the retirement age, the consolidation of all independent workers' pension funds in one, and lower replacement rates. The second draft law concerns the commencement of a second pillar system.[13] These draft laws are steps in the right direction, albeit both still need to be approved by the Parliament. According to actuarial projections, the proposed reform to the first pillar would improve the pension funds' future balances. However, it would not bring long-term sustainability to the system. The independent workers' fund would remain in deficit over the entire projection period, thus requiring additional transfers from the state budget. Moreover, even after the reform, state transfers would continue to increase, albeit at a lower rate, due to an existing rule directly linking government transfers to overall contributions (Figure 7).

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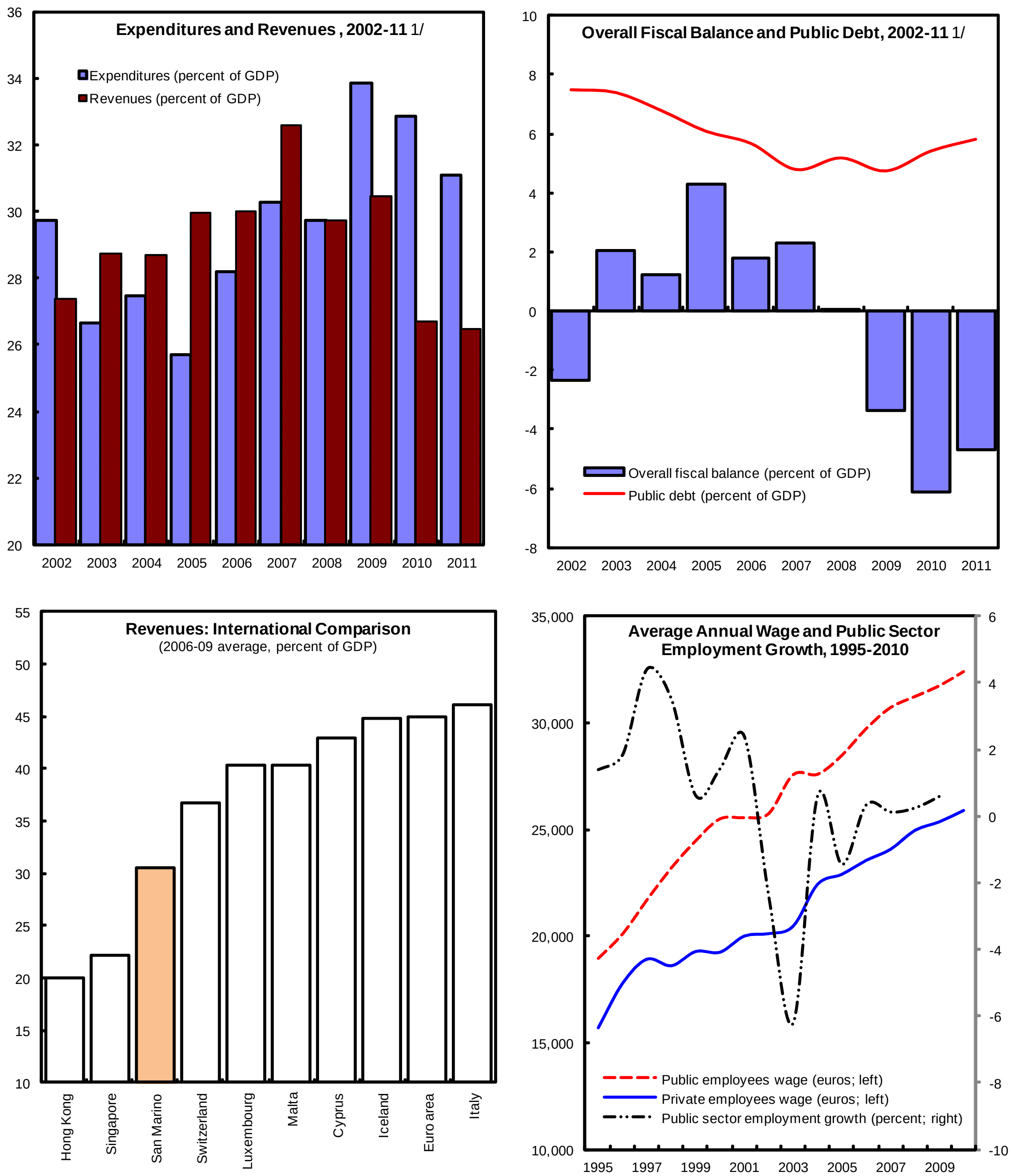
[12] If contingent liabilities associated with higher recapitalization needs for CRSM (e.g., on the order of €400 million) were to materialize, public debt could reach around 40 percent of GDP by 2015.

[13] The second pillar system envisages compulsory participation and shared contributions from employers and employees.

Authorities' views

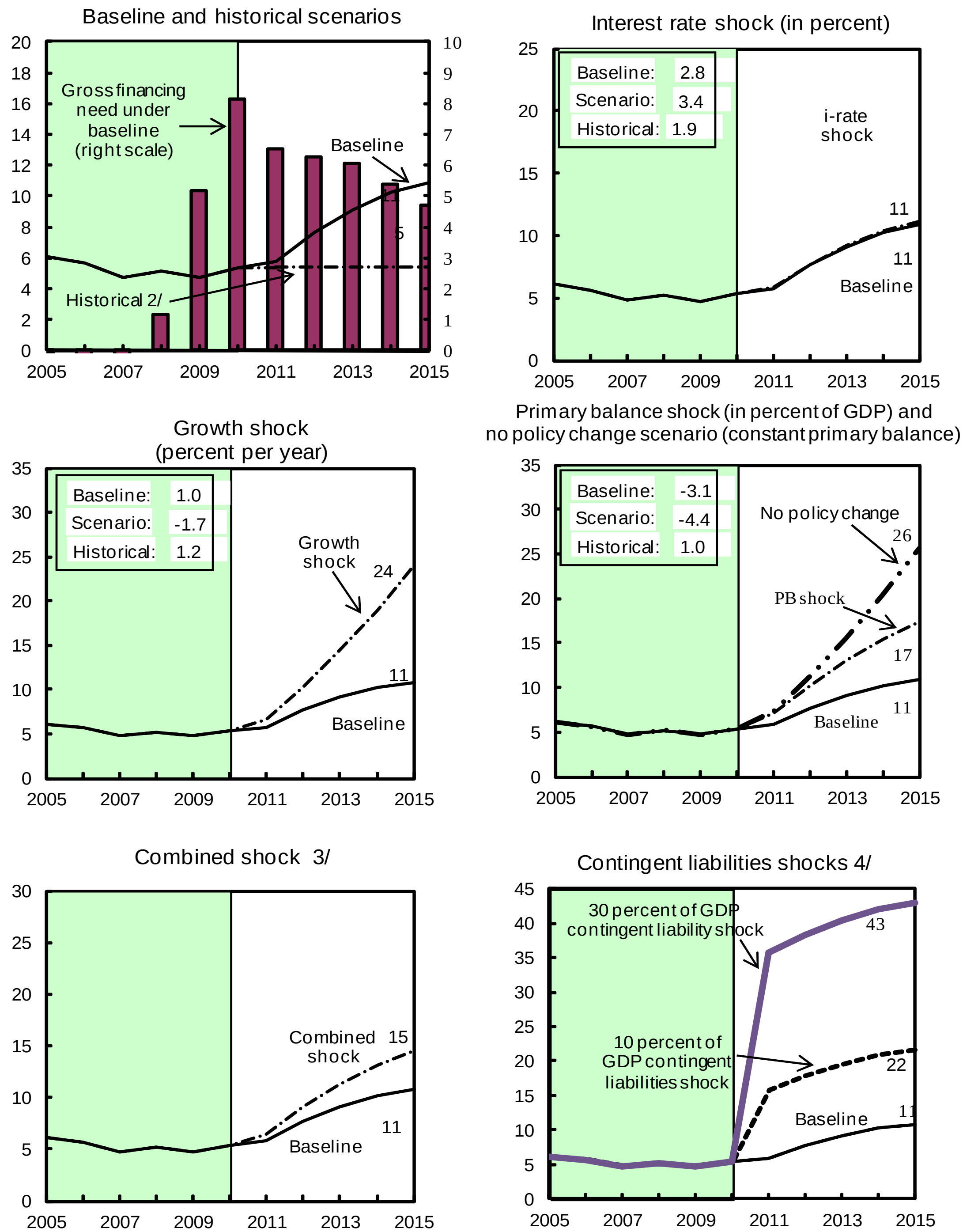
23. **The government broadly shared staff's views about the outlook for fiscal policy.** They agreed with the staff's assessment that the deficit implied by the 2011 budget is rather ambitious, considering the cyclical position and including the need to still approve a number of draft laws concerning public administration and pension reforms, let alone implement these legislations in a timely manner. The authorities also shared staff's view on the need to embed the fiscal consolidation strategy in a more comprehensive framework of permanent fiscal reforms, rather than resort to ad-hoc temporary measures. In a move in that direction, the government plans to carry out a comprehensive reform of the tax system, with the aim of increasing the tax burden on certain groups that, primarily due to tax exemptions and tax evasion, have lagged in their contribution to overall revenues. With the tax reform the government also intends to provide incentives to encourage company mergers and the start up of new enterprises.

Figure 5. San Marino: Fiscal Indicators, 1995-2011



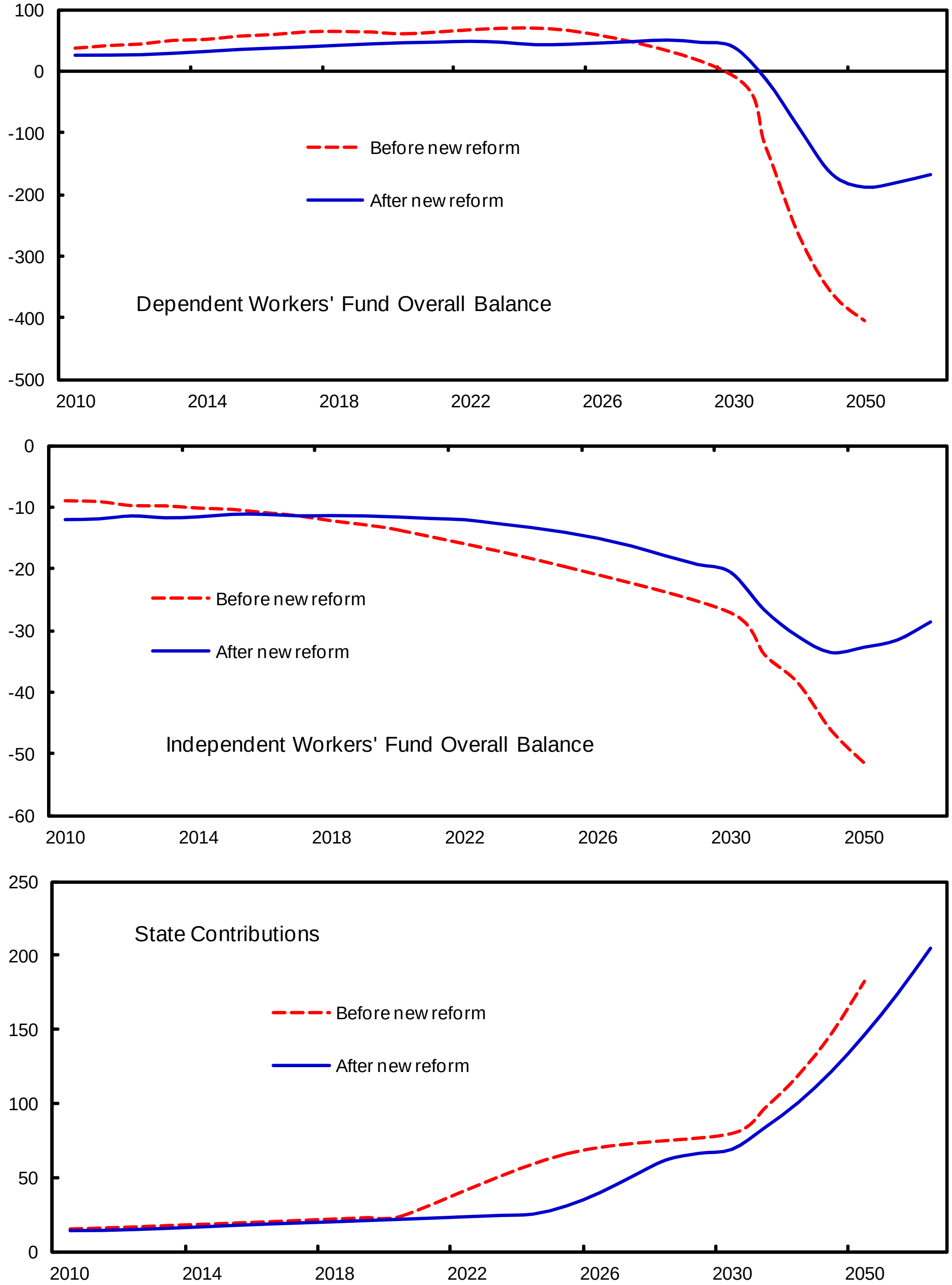
Sources: IMF, World Economic Outlook; Sammarinese authorities; and IMF staff calculations.
1/ 2011 numbers are projections.

Figure 6. San Marino: Central Government Debt Sustainability: Bound Tests, 2010-15 1/
(Public debt in percent of GDP)



Sources: IMF, country desk data; and IMF 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/ Under this scenario, debt would fall to zero. However, historically, the government has not purchased back its debt; therefore, debt/GDP ratio is assumed to remain constant at the end-2010 level.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ 10 and 30 percent of GDP shock to contingent liabilities occur in 2011.

Figure 7. San Marino: Pension Funds Projections, 2010-2060
(Millions of euro)



Sources: Sammarinese authorities; and IMF staff calculations.

C. Structural and Other Policy Issues

24. **Rigidities in product and labor markets have reduced San Marino's competitive position.** The government has taken some steps toward liberalizing and streamlining product markets, albeit cumbersome bureaucratic processes and complicated regulations create barriers to entry in certain non-tradable sectors.[14] Substantial labor market distortions linger as well, including obstacles in hiring highly skilled non-resident workers and a fairly centralized hiring system in the domestic labor market, which hinders market-driven private sector employment. These distortions have contributed to reducing San Marino's competitiveness in recent years, reflected in falling productivity and rising unit labor costs (see Box 3).[15] In this regard, particular attention should be paid to relaxing the hurdles on firms to hire highly skilled non-resident workers. Indeed, in order to develop a new business model successfully, the financial sector needs to acquire rapidly the skills needed to offer a range of new services.

25. **San Marino's participation in the IMF's General Data Dissemination System has strengthened the statistical system, but there is room for improvement.** In line with the 2008 Guidance Note on Data Provision to the Fund for Surveillance Purposes, staff's view is that San Marino's data provision is broadly adequate for surveillance, but has important shortcomings. Indeed, notwithstanding important progress on compilation and dissemination of monetary and financial sector data, national account statistics and fiscal data do not have the detail required by best practice international standards and are only available with a considerable lag.

Authorities' views

26. **The authorities are cognizant of the highly centralized labor market.** While currently there are no specific plans to introduce legislation to ease the hurdles on dismissal and hiring practices, certain elements in the government are mindful of the need to move quickly in this direction, if only to enable the successful transformation of the business model.

27. **The government is keenly aware of the shortcomings in the central statistical system**, and has expressed interest in Fund's technical assistance, especially in the area of compilation and dissemination of national accounts statistics.

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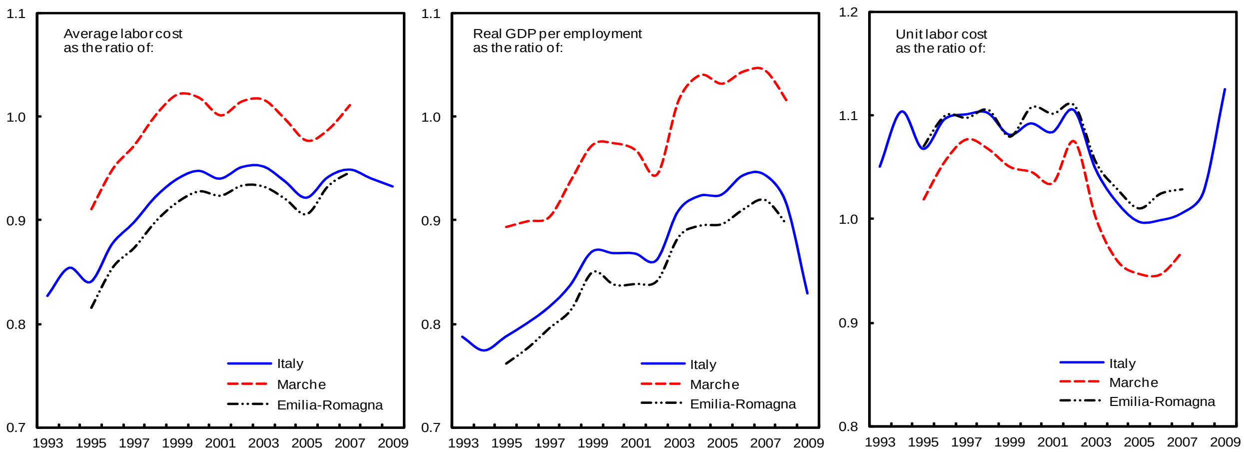
[14] For example, while there are no outright restrictions on foreign ownership of property in San Marino (albeit foreign ownership in the commercial sector is restricted), an authorization from the Council of Twelve, which consists of the two Captain Regents and other Parliamentarian members, is required.

[15] See also accompanying *Selected Issues* Paper entitled: "Assessing San Marino's Competiveness."

Box 3. Losing Competitiveness

A number of indicators point to a loss in competitiveness. San Marino's payroll taxes, effectively amounting to 23 percent of gross pay, compared to Italy's 40 percent, have made it able to maintain an average labor costs below that of Italy and the neighboring regions of Emilia-Romagna and Marche. However, while prior to the global financial crisis the economy had experienced a steady improvement in relative productivity, the substantial output contraction over the past three years led to a significant decline in productivity, and thus to a sharp increase in unit labor costs.

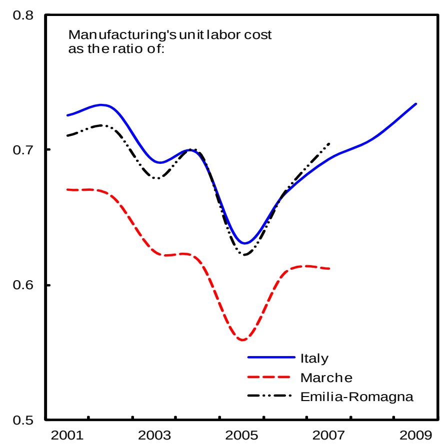


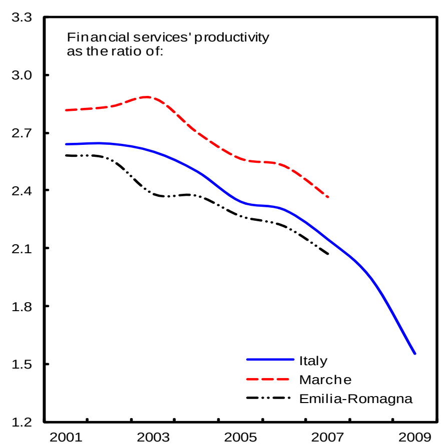
Sources: ISTAT; Sammarinese authorities; UPECEDS; and IMF staff calculations.

Stiffer competition from abroad. In the manufacturing sector, which accounted for about 40 percent of pre-crisis GDP, relatively low-cost labor used to be the predominant incentive for Italian firms to set up factories in San Marino. However, these operating cost advantages are becoming insufficient to restore competitiveness, especially as manufacturing firms face stiffer competition from fast growing emerging markets, where low-cost labor is abundant. In the financial sector, which accounts for almost 20 percent of GDP and which has acted as a principal driver of San Marino's economic growth for many years, labor productivity has been continually declining throughout the past decade.

A key obstacle is the Sammarinese labor market, which is plagued by severe rigidities, mainly resulting from a centralized employment system and extensive impediments on hiring nonresident workers. In particular, any hiring requires an involvement from the Labor Office, a body within the Ministry of Labor, where, for example, private sector firms are obliged to interview all candidates shortlisted by the Labor Office before an open search can be conducted. Similarly, dismissals of workers with an open-ended contract require an agreement among the Labor Office, the trade union and the employer's association. Moreover, labor market practices are largely based on a 1961 law, which renders an outdated regulatory framework.

A successful repositioning of the economy is essential to achieve durable competitiveness gains. Prevailing labor market rigidities will need to be eased, as a remodeled financial system critically depends on the ability of financial institutions to promptly acquire new skills. Similarly, the manufacturing sector needs to restructure to boost productivity in the aftermath of the long recession.





Sources: ISTAT; Sammarinese authorities; UPECEDS; and IMF staff calculations.

IV. Staff Appraisal

28. **A long recession is expected to end this year, but downside risks remain**. Real GDP might finally recover in 2011, but growth is projected to be meager at best. Risks to the outlook are mainly on the downside. Financial sector profitability and employment are likely to be depressed, due to the substantial compression in banks' balance sheets and the need to continue to adjust to new regulations and develop a new business model. Strengthening economic and financial relations with Italy will be vital to support sustainable economic growth and to facilitate a successful repositioning of the economy.

29. **In the aftermath of the tax amnesty, the central bank has taken steps to bolster liquidity.** Sammarinese banks withstood the significant deposit outflow, but their liquid assets contracted. The introduction of a reserve requirement system and the development of a domestic interbank market have played an important role in building up liquidity. Moreover, the proposed implementation of a new arrangement whereby securities held by Sammarinese banks are pooled and used by the CBSM as collateral for repo agreements with foreign counterparties would further enhance system liquidity.

30. **The authorities have made important strides in responding to the 2009 FSAP recommendations, but more should be done to strengthen the financial system.** They have taken measures to enhance the independence and resources of the CBSM, buttress supervisory functions, strengthen AML/CFT defenses, and improve the central bank's liquidity provisions. However, more needs to be done in order to fully meet international standards. The authorities should continue to bolster CBSM independence, including by appointing a new Head of Supervision. Moreover, they should provide both CBSM and FIA with the additional resources they have sought to implement the new regulatory regime effectively. The central bank should continue to seek to secure contingent credit lines with other central banks.

31. **A key priority is to shore up the financial position of the largest bank.** The authorities are properly monitoring the resolution process of the Delta Group, while a recapitalization plan for CRSM is being considered. In that regard, the authorities should proactively evaluate contingency plans to buttress the financial position of CRSM.

32. **The financial system requires a new business model.** The relaxation of strict bank secrecy and the adoption of tighter regulations mean that the old business model is no longer sustainable. The authorities and the private sector are right to undertake a strategic review of the financial system's prospects. Priority should be given to the development of fee-based services that do not rely on bank secrecy, while containing the expansion of domestically-owned banks' balance sheets beyond the capacity of the limited lender of last resort facilities of the central bank. This may be difficult to implement rapidly, but is worth considering as a longer-term solution. At the same time, strengthening relationships with reputable foreign banks would help Sammarinese banks better identify foreign investment opportunities.

33. **The measures taken to contain the fiscal deficit are important, but the strategy needs to be strengthened.** In particular, there is scope to embed the fiscal consolidation strategy in a more comprehensive framework of permanent reforms. For example, ongoing public administration and enterprise reforms should be accelerated and geared toward cuts in public sector employment through attrition, while the current system of subsidies, including on utility prices, needs to be revised. On the revenue side, comprehensive tax reforms should be considered, including through reductions in tax exemptions and tax evasion.

34. **The proposed new pension reforms are steps in the right direction.** But, more can be done to strengthen the long-term financial position of the pension funds. In this regard, quick legislative approval and full implementation of a second pillar framework will enhance the sustainability of the system. The authorities should also take advantage of the new reforms to revise the current rule under which state transfers are automatically linked to total contributions, which implies automatic increases in central government pension expenditure.

35. **Easing rigidities in labor markets are vital to restore competitiveness.** Particular attention should be paid to relaxing the obstacles on firms to hire highly skilled non-resident workers. This will be essential for San Marino to develop a sustainable business model and regain competitiveness.

36. **Meeting international standards for national account statistics and general government accounts is a key priority.** The availability of reliable statistics on current economic conditions and up-to-date transparent and comprehensive general government accounts is critical to designing appropriate economic policies and preparing realistic budgets. In particular, devoting additional resources to meet international standards for national account statistics should enable the production of timely and accurate GDP estimates and projections. This would also help San Marino achieve the aim of greater international integration. In this regard, the staff welcomes the authorities' request for technical assistance.

37. It is recommended that the next Article IV consultation with San Marino be held on the standard 12-month cycle.

Table 1. San Marino: Selected Economic and Social Indicators, 2005-2011

						Projections	
	2005	2006	2007	2008	2009	2010	2011
Activity and prices							
Real GDP (change in percent)	2.4	3.8	3.5	-1.1	-13.0	-0.9	0.8
Domestic demand	2.0	0.4	0.7	-15.4	-20.7	…	…
Final consumption	2.1	1.7	1.5	2.3	-0.9	…	…
Fixed investment	1.2	0.1	-5.5	-27.8	-36.7	…	…
Net exports (contribution to growth)	0.3	3.4	2.8	14.1	4.1	…	…
Exports	1.3	11.2	6.2	9.4	-16.6	…	…
Imports	1.1	9.1	4.7	2.4	-19.9	…	…
Industrial production (change in percent)	4.7	7.2	3.1	1.3	-4.1	6.9	…
Employment (change in percent)	2.2	1.7	3.2	3.5	-0.3	-0.8	…
Unemployment rate (average; percent)	3.6	3.3	3.0	3.1	4.5	4.9	…
Inflation rate (average; percent)	1.7	2.1	2.5	4.1	2.4	2.1	1.9
Nominal GDP (millions of euros)	1,106	1,171	1,233	1,259	1,102	1,115	1,145
Public finances (percent of GDP)							
Overall balance	4.3	1.8	2.3	0.0	-3.4	-6.1	-4.6
Primary balance	4.5	2.0	2.6	0.3	-3.2	-6.0	-4.4
Gross debt	6.1	5.7	4.8	5.2	4.7	5.4	5.8
Money and Credit							
Bank lending (change in percent) 1/	…	…	…	14.9	13.0	-9.1	…
Private credit (change in percent) 2/	16.2	22.6	19.4	10.4	8.7	-12.5	…
Net foreign assets (percent of GDP) 2/	99.3	49.2	57.9	43.5	5.0	-12.3	…
Commercial banks	72.1	18.2	22.2	3.2	-43.2	-39.2	…
Central bank	27.1	31.1	35.7	40.3	48.2	26.9	…
External accounts (percent of GDP)							
Trade balance 3/	-3.7	-0.3	2.4	16.6	24.0	22.3	…
Exports 3/	184	197	202	223	214	166	…
Imports 3/	188	197	200	207	190	144	…
Gross international reserves (millions of U.S. dollars) 2/	354	479	648	707	790	391	…
Number of tourists (millions)	2.11	2.14	2.16	2.11	2.06	1.98	…
Exchange rate							
Euros per U.S. dollar (average)	0.80	0.80	0.73	0.68	0.72	0.76	…
Bilateral exchange rate wrt. Italy (average) 4/	100	100	101	101	103	104	…
Real effective exchange rate (Italy, average)	100	100	100	102	103	99	…
Financial Soundness Indicators (percent)							
Regulatory capital to risk-weighted assets	23.1	18.9	17.5	16.9	16.9	…	…
Nonperforming loans to total loans 2/ 5/	…	…	…	4.2	8.5	10.0	…
Provisioning to total loans 1/	4.4	4.5	4.7	3.2	2.9	4.7	…
Social Indicators							
GDP per capita (2009) 6/	48,959	U.S. dollar					
Ratio of GDP per capital of:							
Italy	1.38						
EU-15	1.27						
Land area	61.2	sq km					
Population (November 2010)	31,871						
Population density (November 2010)	521	per sq km					
Life expectancy at birth, total (2006)	82.2						
Life expectancy at birth, male (2006)	79.4						
Life expectancy at birth, female (2006)	85.1						
Infant mortality rate per 1,000 live births (2008)	1.2						
Literacy, adult (2008)	81.6						

Sources: Sammarinese authorities; World Bank; and IMF staff estimates.

1/ As of October 2010.
2/ As of June 2010.
3/ Based on national account data.
4/ As of November 2010.
5/ Nonperforming loans include both bad loans and problem loans.
6/ GDP per capita overstates income per worker because Italian commuters account for a quarter of the Sammarinese labor force.

Table 2. San Marino: Financial Soundness Indicators, 2004-2010

	2004	2005	2006	2007	2008	2009	2010	Latest Data
Capital adequacy ratios (percent)								
Regulatory capital to risk-weighted assets	22.8	23.1	18.9	17.5	16.9	16.9	…	…
Capital to assets	12.1	11.6	10.9	10.8	10.7	11.1	…	…
Asset quality ratios (percent)								
Nonperforming loans to total loans 1/	…	…	…	…	4.2	8.5	10.1	Jun-10
Nonperforming loans to capital 1/	…	…	…	…	18.4	42.1	…	…
Provisioning to total loans	5.0	4.4	4.5	4.7	3.2	2.9	4.2	Jun-10
Provisioning to total NPLs	…	…	…	…	77.2	34.4	41.4	Jun-10
Earning and profitability (percent)								
Return on assets (ROA) 2/	0.8	0.2	0.9	1.2	0.8	-1.4	0.2	Jun-10
Return on equity (ROE) 2/	6.7	2.0	8.4	10.7	7.6	-13.1	1.4	Jun-10
Return on equity (ROE) 3/	5.1	4.1	7.9	12.1	10.0	-14.4	1.5	Jun-10
Return on equity (ROE) 4/	3.8	1.1	4.1	4.4	4.0	4.1	1.3	Jun-10
Interest margin to gross income	48.2	47.8	46.9	43.9	43.5	36.8	39.2	Jun-10
Non-interest expenses to gross income	23.1	22.9	20.9	18.3	17.7	20.5	32.1	Jun-10
Trading income to gross income	2.8	2.4	0.3	-4.2	-12.6	7.8	0.3	Jun-10
Administrative expenses to non-interest expenditures	89.1	89.9	89.9	91.5	92.1	93.6	95.1	Jun-10
Liquidity (percent)								
Liquid assets to total assets 5/	53.5	51.0	42.5	41.9	42.0	28.9	23.9	Jun-10
Liquid assets to short-term liabilities 6/	78.9	90.4	90.3	96.3	103.5	81.0	74.1	Jun-10
Loans to deposits	54.8	55.6	68.8	66.9	75.2	88.5	97.6	Oct-10
Interest rates (basis points)								
Spread between lending and deposit rates	…	…	…	496	567	478	482	Jun-10

Sources: CBSM; and IMF staff calculations.

1/ Nonperforming loans include both bad loans and problem loans.
2/ Before extraordinary items and taxes.
3/ After extraordinary items and taxes, and before provision to fund for general banking risk.
4/ After extraordinary items and taxes, and after provision to fund for general banking risk.
5/ Liquid assets include cash in vault, loans to banks on demand, and securities.
6/ Short-term liabilities include due to banks and customers on demand, and repos.

Table 3. San Marino: Consolidated Balance Sheet of the Banking Sector, 2009-2010
(millions of euros)

	June 2009			June 2010		
	Total	Domestic-owned	Foreign-owned	Total	Domestic-owned	Foreign-owned
ASSETS						
Cash and other values	49	33	17	30	16	15
Loans to banks:	1,083	594	489	1,322	951	371
a) on demand	827	389	438	372	169	203
b) other loans	256	205	51	950	782	168
Loans to customers	5,434	3,898	1,536	4,642	3,169	1,473
Bond portfolio and other debt securities:	3,925	1,838	2,086	1,647	926	720
a) issued by public entities	84	…	…	190	56	134
b) issued by banks	3,219	…	…	1,039	568	471
c) issued by other financial entities	487	…	…	366	299	66
d) issued by other entities	135	…	…	52	3	49
Shares, interests and other equity securities	72	60	12	58	50	8
Equity investment	179	150	29	151	122	29
Other assets	737	346	391	685	356	328
Accruals and prepayments	57	31	26	36	25	11
Total assets	**11,537**	**6,950**	**4,587**	**8,570**	**5,615**	**2,956**
LIABILITIES						
Due to banks:	164	143	22	641	469	172
a) on demand	52	39	13	158	58	101
b) on term or with notice	113	104	8	483	411	72
Due to customers:	3,903	2,116	1,787	2,895	1,637	1,259
a) on demand	3,629	1,985	1,645	2,608	1,522	1,086
b) on term or with notice	274	55	219	287	115	172
Debt securities:	5,504	3,335	2,168	3,213	2,293	919
a) bonds	668	487	180	901	710	191
b) certificates of deposit	3,659	2,652	1,006	2,311	1,583	728
c) other instruments	1,178	196	982	0	0	0
Other liabilities	546	314	232	492	276	216
Accruals and deferred income	41	29	12	22	15	7
Retirement allowance	2	0	2	2	0	2
Funds for risk and charges:	51	38	13	193	184	9
a) post-retirement benefit obligations	22	22	0	23	22	0
b) tax liabilities	15	4	11	12	4	8
c) other provisions	14	12	2	159	157	1
Reserve for possible loan losses	28	28	0	12	10	2
Total liabilities	**10,240**	**6,004**	**4,236**	**7,470**	**4,884**	**2,586**
Capital						
Fund for general banking risks	261	258	4	47	42	5
Subordinated debt	0	0	0	55	38	17
Share capital	678	524	154	680	513	167
Share premium	12	2	10	12	2	10
Reserves:	287	128	159	292	127	164
a) ordinary reserve	136	41	95	149	48	101
b) extraordinary reserve	104	51	53	113	53	61
c) other reserves	47	36	11	29	27	2
Retained earnings	-5	-5	0	2	2	0
Net profit	64	40	24	13	6	7
Total capital	**1,297**	**947**	**350**	**1,101**	**731**	**370**

Sources: CBSM; and IMF staff calculations.

Table 4. San Marino: Public Finances, 2006–11 1/
(Percent of GDP)

	2006	2007	2008	2009	2010 Estimates	2011 Budget	2011 Forecast
Central Administration Operations							
Revenues 2/	30.0	32.6	29.8	30.5	26.7	27.1	26.5
Tax	24.3	26.9	24.1	23.6	20.3	21.3	20.8
Direct 2/	9.3	9.1	9.2	9.2	7.6	9.0	8.5
Import tax 2/	10.5	13.1	10.1	9.5	8.5	7.7	7.7
Other indirect taxes	4.4	4.7	4.7	4.9	4.2	4.5	4.5
Non-Tax 2/ 3/	5.7	5.7	5.7	6.9	6.4	5.8	5.7
Expenditure	28.2	30.3	29.7	33.9	32.8	30.2	31.1
Current expenditure	25.8	26.5	24.9	28.4	28.6	26.2	27.0
Wages & Salaries	8.8	8.8	8.9	10.4	10.9	10.4	10.4
Transfers to Public Sector	10.7	10.6	11.0	13.0	12.8	11.3	12.2
o/w ISS	7.4	7.6	7.7				
Transfers to Private Sector	1.0	1.0	1.1	1.2	1.1	1.0	1.0
Interest Payments	0.3	0.3	0.3	0.2	0.1	0.2	0.2
Others 4/	5.0	5.9	3.6	3.6	3.6	3.2	3.2
Capital expenditure	2.4	3.8	4.8	5.5	4.3	4.0	4.0
Transfers to Public Sector	0.9	1.7	2.3	3.2	2.6	2.0	2.0
Others	1.5	2.1	2.6	2.3	1.7	2.0	2.0
Balance (including transfers)	1.8	2.3	0.0	-3.4	-6.1	-3.1	-4.6
Primary Balance	2.0	2.6	0.3	-3.2	-6.0	-2.9	-4.4
Financing	-1.8	-2.3	0.0	3.4	6.1		4.6
Net Debt Financing	-0.5	-0.3	-0.3	-0.5	0.7		0.5
Change in Deposits	-4.9	-1.8	-3.9	0.6	3.5		2.6
Change in Net Government Arrears 5/	3.4	-0.2	4.1	3.2	1.5		1.0
Asset Sales	0.2	0.0	0.2	0.1	0.5		0.4
Consolidated Government							
Overall balance of the consolidated government (excluding transfers)	2.0	2.8	-0.4	-5.6	-7.1		
Central administration operations (excluding transfers)	12.0	13.1	12.0	11.1	7.2		
Public enterprises (excluding transfers)	-2.8	-3.0	-4.8	-5.6	-3.8		
Social security fund (excluding transfers)	-7.3	-7.3	-7.6	-11.1	-10.5		
Memorandum Items:							
Public debt	5.7	4.8	5.2	4.7	5.4		5.8
Net government arrears 5/	-12.4	-11.1	-14.8	-20.0	-21.2		-21.7
Government deposits	16.4	17.4	21.0	23.3	19.6		16.4
Nominal GDP (In millions of euros)	1,171	1,233	1,259	1,102	1,115		1,145
Real GDP growth (y-o-y percent change)	3.8	3.5	-1.1	-13.0	-0.9		0.8
Change in GDP deflator (y-o-y percent change)	1.9	1.7	3.2	0.6	2.1		1.9

Sources: Sammarinese authorities; and staff estimates.

1/ Accrual basis.
2/ Net of tax reimbursements.
3/ Includes custom duties, state monopolies, other special revenues, revenues from financial assets, interests on credits and deposits.
4/ Includes purchases of goods and services, remunerations for consultancies, contribution to interest payments on publicly subsidized loans and transport costs.
5/ Includes tax receivables and refunds, arrears toward suppliers, transfers to and from the rest of the public sector, other payables and receivables.

Table 5. San Marino: Central Government Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
Baseline: central government debt 1/	6.1	5.7	4.8	5.2	4.7	**5.4**	**5.8**	**7.6**	**9.1**	**10.2**	**10.9**	**0.1**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Change in central government debt	-0.7	-0.4	-0.9	0.4	-0.4	0.7	0.4	1.9	1.5	1.1	0.6	
Identified debt-creating flows (4+7+12)	-4.9	-2.3	-2.7	-0.3	4.1	5.6	4.0	4.0	3.4	2.5	1.6	
Primary deficit	-4.5	-2.0	-2.6	-0.3	3.2	6.0	4.4	4.0	3.3	2.3	1.4	
Revenue and grants	30.0	30.0	32.6	29.8	30.5	26.7	26.5	25.9	25.7	25.7	25.7	
Primary (noninterest) expenditure	25.4	28.0	30.0	29.5	33.7	32.7	30.8	29.9	29.0	28.1	27.2	
Automatic debt dynamics 2/	0.0	-0.1	0.0	0.2	0.9	0.1	0.1	0.1	0.1	0.1	0.1	
Contribution from interest rate/growth differential 3/	0.0	-0.1	0.0	0.2	0.9	0.1	0.1	0.1	0.1	0.1	0.1	
Of which contribution from real interest rate	0.1	0.1	0.2	0.1	0.2	0.1	0.1	0.2	0.2	0.2	0.2	
Of which contribution from real GDP growth	-0.2	-0.2	-0.2	0.1	0.8	0.0	0.0	-0.1	-0.1	-0.1	-0.1	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	-0.3	-0.2	0.0	-0.2	-0.1	-0.5	-0.4	-0.1	-0.1	0.0	0.0	
Privatization receipts (negative)	-0.3	-0.2	0.0	-0.2	-0.1	-0.5	-0.4	-0.1	-0.1	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	4.2	1.9	1.8	0.7	-4.5	-5.0	-3.6	-2.2	-1.9	-1.4	-1.0	
Central government debt-to-revenue ratio 1/	20.3	18.9	14.6	17.4	15.5	20.2	21.8	29.5	35.6	39.8	42.2	
Gross financing need 6/	-0.1	-0.8	-1.2	1.2	5.2	8.1	6.5	6.3	6.0	5.4	4.7	
in billions of U.S. dollars	-1.4	-12.4	-20.1	21.5	79.2	118.5	96.0	94.6	93.5	85.7	77.3	
Scenario with key variables at their historical averages 7/						**5.4**	**0.4**	**-2.9**	**-5.9**	**-8.2**	**-10.2**	**-0.1**
Scenario with no policy change (constant primary balance) in 2010-2015						**5.4**	**7.4**	**11.2**	**15.4**	**20.3**	**25.6**	**0.4**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	2.4	3.8	3.5	-1.1	-13.0	-0.9	0.8	1.1	1.1	1.1	1.1	
Average nominal interest rate on public debt (in percent) 8/	4.0	4.4	4.7	5.9	3.3	3.2	4.2	5.4	5.0	4.9	4.7	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	2.3	2.4	3.0	2.6	2.6	1.1	2.3	3.4	3.0	2.7	2.5	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-11.6	11.4	10.3	-6.6	7.2	-6.1	-1.8	-0.5	-0.5	-0.5	-0.5	
Inflation rate (GDP deflator, in percent)	1.7	2.0	1.7	3.3	0.6	2.1	1.9	2.0	2.0	2.1	2.2	
Growth of real primary spending (deflated by GDP deflator, in percent)	-4.2	14.2	11.1	-2.9	-0.6	-3.8	-4.9	-2.0	-2.0	-2.2	-2.2	
Primary deficit	-4.5	-2.0	-2.6	-0.3	3.2	6.0	4.4	4.0	3.3	2.3	1.4	

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP. Under this scenario, debt would fall to zero. However, historically, the government has not purchased back its debt; therefore, debt/GDP ratio is assumed to remain constant at the end-2010 level (see Figure 6).

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Appendix I. Action Taken in Response to FSAP Recommendations

Recommendation	Action Taken
Secure contingent emergency lines of credit with other central banks.	--Discussions held but no other central bank has yet agreed to provide such credit.
Recapitalize banks that do not meet prudential requirements.	--No change to transitional measures allowing for departure from capital asset ratios, although in December 2010, all banks except one met the 11 percent minimum capital asset ratio.
Strengthen supervision, particularly full on-site inspections.	--Total staff in supervision department of CBSM increased from 26 to 30, with 3 further posts agreed. --Number of staff needed for supervision is being reduced as number of financial companies fell from 53 in 2008 to 37 in 2010. --No change to restrictions on recruitment of staff from outside San Marino – holding back recruitment of senior experienced staff. --Total number of inspections increased from 22 to 23), including for supervision (from 7 to 14, of which full scope inspections from 3 to 11). --Total number of off-site preventative and remedial actions increased from 181 in 2009 to 327 in 2010. Sanctions increased from 7 in 2009 to 10 in 2010.
Facilitate cross-border flows of information and allow foreign supervisors to make on-site visits to foreign banks in San Marino.	--Amendment made to Article 103 of Law 165 designed to permit banks to disclose information to parent banks. --Article 7 of decree-law 36 (February 24, 2011) allows on-site visits by foreign supervisors, subject to a bilateral agreement between supervisory agencies.
Ensure that financial institutions, particularly fiduciary firms, are properly and effectively implementing the CDD requirements.	--On-site inspections by CBSM concerning AML/CFT issues increased from 4 in 2009 to 13 in 2010. Special focus on AML/CFT obligations of financial companies (full inspections increased from 2 to 10). --Comments on AML/CFT matters in CBSM inspection reports increased from 3 to 5 in 2009-10. --64 reports on suspicious transactions by fiduciary companies made by CBSM to FIA. --FIA inspections increased from 20 in 2009 to 27 in 2010.
Introduce a new governance model for the CBSM.	Some changes made to Governance: --CBSM Governing Council (GC) given greater responsibility for actions of CBSM; --Role of State Congress in special administration removed; --Unanimous vote of GC to remove Director General and grounds for dismissal specified in the law; --Role of State Congress and Committee for Savings and Credit removed from appointment of GC; --Added list of positions incompatible with membership of GC; --Three-year budget agreed. However: No change to State Congress ability to refuse a license approved by CBSM; No change in transparency of appointment procedure of GC members.

Recommendation	Action Taken
Introduce prudential measures that contain banks' liquidity risks (such as minimum liquidity ratios with the CBSM).	--Reserve requirement of 8% of total deposits, waived for banks that provide liquidity to other banks. --Voluntary scheme for depositing excess liquidity with CBSM. --New Decree-Law enacted to permit CBSM to act as lender of last resort. --Measures prompted €300 million interbank lending in 2010.
Upgrade financial regulation, preferably in line with the EU framework.	--No change to prudential regulations, pending agreement to adopt EU acquis in return for use of Euro.
Take all possible steps to accelerate the transition period to full compliance with the regulations on loan concentration.	--No change to transitional measures.
Increase staff of the Financial Intelligence Agency (FIA), the CBSM supervision units and the Judiciary responsible for AML/CFT.	--In April 2010, FIA requested increased staff, but no response yet given to request.
Introduce measures to facilitate self-insurance among banks.	--See description of liquidity measures above. --No other action taken.
Finalize supervision manuals.	--On-site supervision manual finalized. Other manuals being completed.
Seek to obtain access to the EU payment system, and ECB refinancing facilities.	--Access sought but not yet achieved.
Undertake reform of fiduciary companies in order to strengthen transparency in corporate ownership and clarify the scope of activities in which these companies can engage.	--New laws prohibit bearer shares and introduce corporate liabilities of legal persons. --CBSM circulars impose prudential rules on financial companies, including the limitation of their role to 4 specified activities. --Circulars also increase reporting requirements including details of the persons represented by fiduciary companies and identification of beneficial owners. --Number of financial companies decreased from 53 at end-2008 to 37 in 2010. Assets under management by fiduciary companies reduced from €3.3 billion in mid-2009 to €1.5 billion by mid-2010. --Article 12 of decree-law 36 (February 24, 2011) requires fiduciary companies that are shareholders of foreign companies to disclose information to the supervisory authorities.
Enhance collaboration between the FIA and the CBSM in the area of financial sector AML/CFT supervision.	--Increased coordination between FIA and CBSM. --Agreed risk assessment undertaken of institutions in respect of AML/CFT. --Exchange of information on all AML/CFT matters found in inspections, including reporting findings during inspections. --Review meetings held to reassess risk of institutions. --1 joint inspection undertaken. More planned.
Reconsider some of the FIA's non-core financial intelligence unit's (FIU) responsibilities (such as the power to act as judicial police on delegation from the judicial authority) in the light of the FIA's limited human resources.	--No change to responsibilities.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

Staff Report for the 2010 Article IV Consultation—Informational Annex

Prepared by the Staff Representatives for the 2010 Consultation with San Marino
(In Consultation with Other Departments)

February 24, 2011

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APPENDIX I. SAN MARINO: FUND RELATIONS

(February 4, 2011)

- **Article IV mission**: January 4-14, 2011.
- **Staff team:** N. Epstein (head), P. Jeasakul and E. Zoli (all EUR), and R. Pratt (consultant).
- **Key country interlocutors**: Secretary of State for Finance and Budget, Secretary of State for Foreign Affairs, President and Director General of CBSM, other senior public sector officials, employers' associations and private sector participants. A press conference was held at the end of the mission.
- **Data:** San Marino began participating in the Fund's General Data Dissemination System on May 16, 2008, making at the time a major step forward in the development of its statistical system. However, data shortcomings remain (Annex II).

I. **Membership Status**: San Marino joined the IMF on September 23, 1992 and accepted the obligations of Article VIII of the Articles of Agreements.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	17.00	100.00
Fund holdings of currency	12.90	75.88
Reserve position in Fund	4.10	24.13

III. **SDR Department:**	SDR Million	Percent Allocation
Allocation	15.53	100.00
Holdings	16.68	107.40

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangements**: 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. The central monetary institution is the Banca Centrale della Republica di San Marino. 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's exchange system is free of 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]

VIII. **Article IV Consultation**: San Marino is on a 12 months cycle. The previous Article IV mission took place during November 13-23, 2009; the consultation was concluded on February 2, 2010 (Country Report No. 10/67). The staff report and associated Executive Board's assessment are available at:
http://www.imf.org/external/pubs/cat/longres.aspx?sk=23706.0

IX. **Technical Assistance**

Year	**Dept. Purpose**	**Date**
1997	STA Multisector assistance	3/97
2004	STA Monetary and Financial Statistics	1/29–2/4
2005	MFD Deposit insurance	11/05
2008	STA GDDS metadata development	03/08
2008	LEG AML/CFT	11/08

X. **Resident Representative**: None.

[1] EU Regulations are not directly applicable to San Marino as a result of 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 Italy, acting on behalf of the European Union.

APPENDIX II. San Marino: Statistical Issues

Data provision: Progress has been made since San Marino's participation in the IMF's General Data Dissemination System (GDDS) on May 16, 2008, but important weaknesses in the statistical database remain, mainly due to resource constraints. In January 2007, in view of their intention to participate in the GDDS, the authorities named two National GDDS Coordinators and announced their objective to increase the frequency of website updates in order to improve data dissemination. As of February 2010, national and fiscal accounts, as well as monetary and financial sector data are compiled according to international standards but some key statistics (such as real and fiscal data) are available only with delay and, in many cases, are at a lower than standard frequency and detail.

Real sector statistics: National accounts data for 1995 onward have been calculated in accordance with ESA95 and data are compiled annually based on the income approach, with about ten months delay. The authorities have also calculated sectoral contribution. Consumer prices and employment data are available monthly with short delay. An industrial production index based on electricity consumption, launched in 2000, became available monthly in 2009. Consumption and business sentiment indices have been compiled starting in 2007 based on annual household and business surveys.

Government finance statistics: The authorities have provided data for the central government, state owned enterprises, and the social security fund for 2004–10; as well as the budget for 2011-13. However, the data has not been compiled in accordance with IMF standards. In the central government budget, standard financing items, such as amortization and borrowing requirements, are presented as above-the-line items.

Monetary and financial statistics: Since May 1997 the authorities have provided balance sheet data on the commercial banks and the monetary authorities to STA's EIS database. These data are provided on a quarterly basis, with approximately a six-week reporting lag. The authorities have introduced laws and took some measures to improve coverage and timeliness of banks' reporting. The CBSM has expanded data collection to cover the offshore asset management activities of banks. The breakdown of deposits (and other assets and liabilities) between residents and nonresidents and the breakdown of short-term credit by public and private sector components are also available. However, there is no broad money survey. Data on non-bank financial intermediaries is also lacking.

External sector: San Marino does not compile balance of payments accounts. Given the currency union with Italy and the subsequent introduction of the euro, the authorities have not considered this a high priority and have, therefore, not committed the necessary resources. Starting in 2008, trade statistics have been released quarterly with a lag of about six months.

San Marino: Table of Common Indicators Required for Surveillance
(As of February 3, 2010)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange Rates	2/3/11	2/3/11	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Jun 2010	Dec 2010	Q	Q	Q
Reserve/Base Money	Jun 2010	Dec 2010	Q	Q	Q
Broad Money	Dec 2008	Apr 2009	Q	Q	Q
Central Bank Balance Sheet	Jun 2010	Dec 2010	Q	Q	Q
Consolidated Balance Sheet of the Banking System	Jun 2010	Dec 2010	Q	Q	Q
Interest Rates[2]	Jun 2010	Dec 2010	Q	Q	Q
Consumer Price Index	Nov 2010	January 2011	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA				
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2010	Jan 2011	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	2010	Jan 2011	A	A	A
External Current Account Balance	NA [6]				
Exports and Imports of Goods and Services	2009	Nov 2010	A	A	A
GDP/GNP	2009	Nov 2010	A	A	A
Gross External Debt	NA [6]				
International Investment Position	NA [6]				

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign and 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] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[6] The authorities do not compile BOP data and lack the capacity to provide this information to the Fund.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 11/41
FOR IMMEDIATE RELEASE
March 30, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation with San Marino

On March 14, 2011 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with San Marino.[1]

Background

Following two years of economic contraction, led primarily by a sharp decline in fixed investment, the Sammarinese economy remains weak. There were signs of a moderate expansion in manufacturing and commercial activity during the first half of last year, but rising unemployment, stagnant wage growth, and lower confidence have all contributed to a fall in consumption. As a result, real GDP is estimated to have declined by about 1 percent in 2010. This year, the economy could build some momentum, but growth is projected to remain below 1 percent. The fiscal position weakened significantly in 2009-10, mainly due to a sizable decline in revenues, with the deficit rising from 3.4 percent of GDP in 2009 to an estimated 6.1 percent of GDP in 2010.

The financial sector is adjusting to the effects of Italy's 2009-10 tax amnesty, which led to a significant outflow in bank deposits and, consequently, to a considerable decline in the size of banks' balance-sheets. The system has shown resilience to the deposit outflow, but liquidity,

[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. At the conclusion of the discussion, the 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 summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

profitability, and asset quality have deteriorated amid the economic slowdown. Progress has been made on meeting the 2009 Financial Sector Assessment Program (FSAP) recommendations, including strengthening financial regulation, eliminating certain bank-secrecy provisions, and tightening anti money-laundering defenses. Key challenges include the need to shore up the financial position of the largest bank and develop a sustainable new business model for the financial sector.

Executive Board Assessment

Executive Directors, while acknowledging recent steps to address long-standing policy concerns, encouraged the authorities to support medium-term economic prospects through a more effective pursuit of the unfinished reform agenda. In particular, restructuring the financial sector, strengthening economic and financial relations with Italy, and introducing a comprehensive fiscal framework will be key to a successful repositioning of the economy.

Directors noted that the financial sector weathered a period of heightened turbulence and deposit outflows relatively well, and commended the Central Bank of San Marino (CBSM) for its liquidity management. Looking ahead, they encouraged the monetary authorities to address remaining vulnerabilities, including shoring up the financial position of the largest bank, which remains a priority.

Directors recognized progress in response to the 2009 recommendations under the Financial Sector Assessment Program, but called for additional reforms to strengthen the financial system and improve its transparency. Measures taken to enhance the operational autonomy of the CBSM, buttress supervisory functions, and strengthen Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) defenses have been steps in the right direction. However, effective implementation is still lagging in a number of instances. For example, Directors urged the authorities to appoint as soon as possible a Head of Supervision, a position that has remained vacant for over one year.

Directors agreed on the importance of a new business model for San Marino’s financial sector, as the relaxation of bank secrecy and regulations better aligned with international standards undermine the viability of previous business practices. Accordingly, they welcomed strategic reviews underway and looked forward to their recommendations.

Directors welcomed the authorities’ goal to reduce the fiscal deficit, but counseled that the credibility of fiscal plans would be enhanced by a better-articulated consolidation strategy. Cuts in public sector employment through attrition and comprehensive tax reforms could be key elements of such a strategy. Directors also recommended a rapid enactment of the new pension laws to build on progress already made and to safeguard the sustainability of the pension system.

Directors noted the loss in competitiveness of the economy in recent years. In this regard, they considered that easing rigidities in labor markets, in particular impediments to the hiring of skilled non-resident workers, would be desirable.

Directors reiterated their concern about the inadequacy of national account and general government statistics, which hampers policy design and evaluation, and took note of the authorities' request for technical assistance in this area.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with San Marino is also available.

San Marino: Selected Economic and Social Indicators, 2005-2011

						Projections	
	2005	2006	2007	2008	2009	2010	2011
Activity and Prices							
Real GDP (change in percent)	2.4	3.8	3.5	-1.1	-13.0	-0.9	0.8
Unemployment rate (average; percent)	3.6	3.3	3.0	3.1	4.5	4.9	…
Inflation rate (average; percent)	1.7	2.1	2.5	4.1	2.4	2.1	1.9
Nominal GDP (million euros)	1,106	1,171	1,233	1,259	1,102	1,115	1,145
Public Finances (percent of GDP)							
Overall balance	4.3	1.8	2.3	0.0	-3.4	-6.1	-4.6
Primary balance	4.5	2.0	2.6	0.3	-3.2	-6.0	-4.4
Gross debt	6.1	5.7	4.8	5.2	4.7	5.4	5.8
Money and Credit							
Bank lending (change in percent) 1/	…	…	…	14.9	13.0	-9.1	…
Private credit (change in percent)2/	16.2	22.6	19.4	10.4	8.7	-12.5	…
Net foreign assets (percent of GDP) 2/	99.3	49.2	57.9	43.5	5.0	-12.3	…
Commercial banks	72.1	18.2	22.2	3.2	-43.2	-39.2	…
External Sector							
Trade balance (percent of GDP) 3/	-3.7	-0.3	2.4	16.6	24.0	22.3	…
Exports (percent of GDP) 3/	184	197	202	223	214	166	…
Imports (percent of GDP) 3/	188	197	200	207	190	144	…
Foreign reserves (million U.S. dollars)	354	479	648	707	790	391	…
Number of tourists (millions)	2.11	2.14	2.16	2.11	2.06	1.98	…
Euros per U.S. dollar (average)	0.80	0.80	0.73	0.68	0.72	0.76	…
Social Indicators							
GDP per capita (2009)	48,959	U.S. dollar					
Ratio of GDP per capital of:							
Italy	1.38						
EU-15	1.27						
Population (November 2010)	31,871						
Population density (November 2010)	521	per sq km					
Life expectancy at birth, total (2006)	82.2						
Literacy, adult (2008)	81.6						

Sources: Sammarinese authorities; World Bank; and IMF staff estimates.
1/ As of October 2010.
2/ As of June 2010.
3/ Based on national account data.

Statement by Arrigo Sadun, Executive Director for Republic of San Marino and Francesco Spadafora, Senior Advisor to Executive Director
March 14, 2011

The Sammarinese authorities wish to express their appreciation for the Fund's mission team and the high-quality report. They broadly share the thrust of the staff's analysis and recommendations.

San Marino's economy has been trying to recover from the major recession of 2008–2009, which was primarily led by a decline in fixed investment. Growth remained modestly negative in 2010 (at -0.9 percent), and is projected at about 1 percent this year.

The unemployment rate more than doubled since 2008. However, considering the sharp decline in output, the increase was relatively modest as a result of a substantial increase in the usage of the wage-supplemental system over the past two years.

The recovery is still fragile, and construction activity and employment in the manufacturing sector are well below their pre-crisis levels. The financial sector has showed some resilience to the significant deposit outflows that followed the tax amnesty adopted by Italy in September 2009. However, liquidity, profitability, and asset quality have also been affected by the economic slowdown.

Over the medium term, the authorities are working with the private sector to undertake a strategic review of the financial system's prospects, with a view to devising a new business model that does not rely on bank secrecy and is consistent with tighter financial regulation.

Fiscal Policy

The economic slowdown and the decline in revenues from the financial sector caused the fiscal deficit to widen from 3.4 percent of GDP in 2009 to 6.1 percent of GDP in 2010.

The authorities have taken steps to reduce the fiscal deficit. In the three-year rolling budget approved last December, the government introduced a number of consolidation measures, including cuts in transfers to the large public sector, a reduction in the public sector wage bill, and a one-time levy on income tax payers.

With these measures, the authorities expect the central government deficit to decline to about 3.1 percent of GDP in 2011, but recognize that this target is rather ambitious, considering the sluggish recovery, and the need to still approve a number of draft laws and implement them.

However, the authorities agree with the staff on the need to embed the fiscal consolidation strategy into a more comprehensive framework of permanent fiscal reforms, rather than resorting to ad-hoc temporary measures. To this end, the government plans to carry out a comprehensive reform of the tax system, with the aim of increasing the tax burden on certain groups that, primarily due to tax exemptions and tax evasion, have lagged in their contribution to overall revenues. With the tax reform, the government also intends to provide incentives to encourage company mergers and the start up of new enterprises.

As far as the long-term sustainability of the pension funds is concerned, building on the 2005 pension reforms, the government plans to present to Parliament two new draft pension laws. The first draft law concerns the first pillar, and envisages higher contribution rates, greater harmonization of contribution rates across categories of independent workers, an increase in the retirement age, the consolidation of all independent workers' pension funds in one, and lower replacement rates. The second draft law concerns the commencement of a second pillar system.

Financial Sector

The Central Bank of San Marino (CBSM) has taken measures to bolster the banks' liquidity in the face of rising vulnerabilities. A new reserve requirement system, implemented last year, helped spur the development of a domestic interbank lending market. In addition, the CBSM has proposed to implement a new arrangement whereby securities held by Sammarinese banks could be pooled and used by the CBSM as collateral for repo agreements with foreign counterparties, thereby obtaining added liquidity.

The CBSM is further considering: (i) new rules that would permit the securitization of bank loans; (ii) taking on a role in managing the supply and distribution of cash to banks so as to increase efficiency; and (iii) introducing a central register of credit risks so as to ensure that it is aware of the exposure of the banking system to single or connected borrowers.

A recapitalization plan for the Cassa di Risparmio di San Marino (CRSM) is being considered to buttress its financial position in the face of the resolution of Italy's Delta Group, which is largely owned by CRSM and has been under special administration since mid-2009. The CBSM is monitoring the resolution process and evaluating various contingency options.

As noted by staff, the authorities have made progress in responding to the 2009 FSAP recommendations, and have secured passage of important legislation to buttress financial sector supervision. They have taken measures to enhance the independence and resources of the CBSM, to fortify on-site and off-site supervisory functions, and to enable the CBSM to assist in the provision of liquidity to banks. In addition, the staff notes that new regulations have circumscribed the activity of fiduciary companies, enhanced AML/CFT defenses, abolished the use of bearer shares, and tightened customer due diligence requirement.

Improving the Business Environment

The authorities have taken steps toward liberalizing and streamlining product markets so as to support San Marino’s competitive position, but they have stated a more cautious approach than staff on increasing labor market liberalization. This is due to the extremely limited size of the territory and to the upward trend in unemployment as a result of the economic crisis.

In particular, the authorities are cognizant of the highly centralized labor market. While currently there are no specific plans to introduce legislation to ease the hurdles on dismissal and hiring practices, there is awareness of the need to support the transformation of the business model.

San Marino’s participation in the IMF’s General Data Dissemination System has strengthened the statistical system. However, the government is keenly aware of the remaining shortcomings and has expressed interest in the Fund’s technical assistance, especially in the area of compilation and dissemination of national accounts statistics.