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REPUBLIC OF SAN MARINO

April 2015

2015 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2015 Article IV consultation with the Republic of San Marino, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on March 25, 2015, following discussions that ended on January 28, 2015, 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 March 6, 2015.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its March 25, 2015 consideration of the staff report that concluded the Article IV consultation with the Republic of San Marino.
- A **Statement by the Executive Director** for the Republic of San Marino.

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

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REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

March 6, 2015

KEY ISSUES

Context: Over the last half decade, San Marino's economy has managed to weather the implosion of its offshore banking model, the global crisis, and Italy's decision to put San Marino on a tax blacklist. Together, these shocks resulted in a loss of a third of output since 2008, caused banking system NPLs to rise to over 40 percent—with the largest bank requiring 13 percent of GDP in public support—and pushed up net public debt by some 20 percent of GDP (from virtually nil five years ago). Looking forward, the economy is stabilizing, reflecting the inclusion of San Marino in Italy's tax whitelist, but downside risks persist.

Challenges: Advance the restructuring of the banking system, realign fiscal policy with new economic realities, integrate into international markets, and lay solid foundations for sustainable growth.

Key policy recommendations:

- ***Financial sector policy.*** Accelerate the incomplete restructuring of the largest bank. Conduct in-depth asset quality assessments of the other banks in the system. Where needed, assessments should be followed quickly by appropriate plans to bring banks back to meeting regulatory requirements. Facilitate more aggressive NPL management.

- ***Fiscal policy.*** Pursue gradual consolidation of 2½ percent of GDP over five years to put public debt on a sustainable path and rebuild buffers. Focus adjustment on reducing the public sector wage bill, pensions, and health benefits. Increase revenue by reinstating a real estate tax or setting a higher-than-envisioned VAT rate. Establish market access for the sovereign.

- ***Structural policy.*** Enhance competitiveness by improving the business environment. Facilitate the reallocation of resources to the nonbanking sector. Continue to strengthen international cooperation.

Traction of past Fund advice: The authorities undertook measures to achieve fiscal consolidation, consistent with past Fund advice. They have recapitalized the largest bank in the country, in line with Fund advice, but they did not follow Fund recommendations on the modalities of best-practice restructuring (IMF Country Report 14/104).

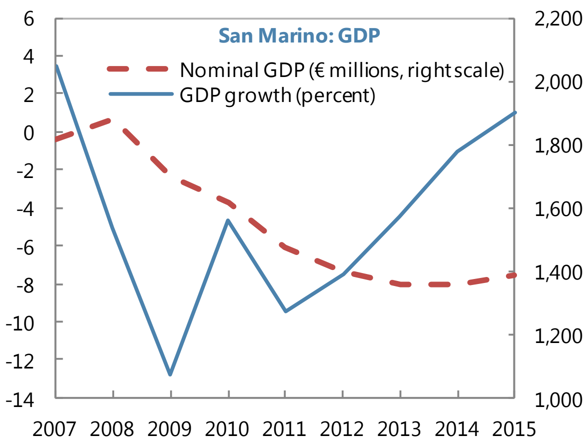
Approved By
Aasim M. Husain (EUR) and Era Dabla-Norris (SPR)

Discussions for the 2015 Article IV consultation were held in San Marino during January 19–28, 2015. The mission comprised Messrs. Tieman (head), Lanau, Mehrez (all EUR), and Parker (MCM). Ms. Spinella and Mr. Cottarelli (OED) joined some of the meetings. The mission met with Minister of Finance Capicchioni, Minister of Foreign Affairs Valentini, Minister of Industry Arzilli, Minister of Labor Belluzzi, Minister of Health Mussoni, Minister of Tourism Lonfernini, Central Bank Director General Giannini, other senior public officials, and representatives from parliament, the private sector, and civil society. Ms. Licudine and Mr. Velazquez-Romero assisted in the preparation of the staff report.

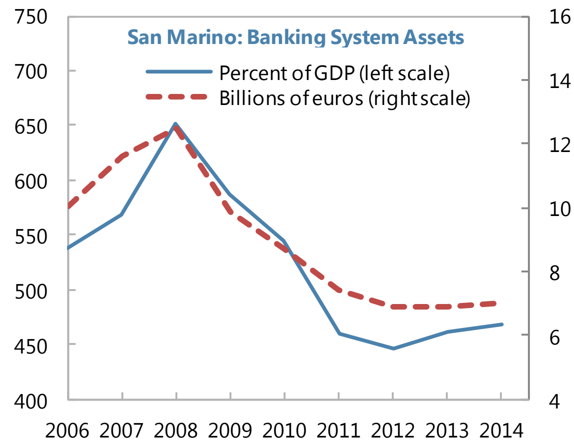
CONTENTS

CONTEXT, OUTLOOK, AND RISKS

1. **San Marino's offshore banking model of economic growth imploded over the last half decade.** The global financial crisis and the inclusion of San Marino on Italy's tax blacklist led to a large outflow of nonresident deposits and a sharp decrease in the size of and asset quality in its financial sector. The country's largest bank has needed three bailouts, following the debt restructuring of its Italian Delta subsidiary. Combined with low external demand due to the crisis in Europe, this led to an extraordinary loss of a third of San Marino's output since 2008. As the offshore banking model of growth will not return, much of this output loss likely represents a permanent level shift in GDP. The banking system remains in transition to a new business model, focused more on domestic lending.



Sources: National Accounts



Source: Central Bank of San Marino

2. **Although a sound fiscal stance before the crisis provided ample buffers, the large output decline and bank recapitalization needs have put the fiscal position under pressure.** The central government balance swung from a surplus of some 2–3 percent of GDP prior to the crisis to a deficit of about 2½ percent of GDP, notwithstanding the authorities' consolidation efforts. This, together with the fall in GDP and bank recapitalization costs, exhausted cash buffers and raised public debt to 23 percent of GDP. Furthermore, the social security fund's position has weakened significantly.

3. **The economy is exhibiting tentative signs of stabilization.** The inclusion in Italy's tax whitelist in late 2014 and stabilization of bank deposits are paving the way for a modest recovery over the next few years. Although GDP fell 4½ percent in 2013, high-frequency data such as business turnover and confidence, and decreasing bank losses, point to a more moderate contraction in 2014. Overall, the economy is estimated to have shrunk by 1 percent in 2014 and to return to modest growth of 1 percent in 2015. Meanwhile, unemployment has risen to over 8 percent.

4. **Similar to a year ago, risks remain tilted to the downside, as the weak financial sector continues to cast a shadow over San Marino's medium-term outlook** (Annex I).

Prolonged slow growth in Italy and the euro area remains a downside risk to growth and the financial sector going forward, through external demand and the quality of banks' Italian assets. Much economic activity is linked closely with Italy, while 42 percent of bank assets and 25 percent of deposits are nonresident, mostly Italian. On the upside, the recent inclusion in Italy's whitelist could stimulate bilateral economic activity more than expected. Still, high nonperforming loans (NPLs) in the banking system and the incomplete restructuring of the largest bank in the country pose vulnerabilities. Should stress in the financial system escalate, further recapitalization needs are likely to arise with direct implications for fiscal balances and growth, increasing the potential for a negative bank-sovereign feedback loop.

5. **In the medium term, San Marino faces the significant challenge of adapting to the new economic environment.** Sustaining growth and job creation will require diversifying away from banking, and integrating more fully into neighboring Emilia-Romagna—as well as Europe and the world.

Authorities' views

6. **The authorities shared staff's assessment that the economy is stabilizing.** In particular, they emphasized that San Marino's inclusion in Italy's tax whitelist and the recent conclusion of a bilateral economic cooperation agreement will provide support to the incipient recovery. The authorities recognized the need for the economy to find a new growth model. Still, they also saw opportunities for the financial sector to grow through increased international activities once the banks will be allowed to operate in Italy as deposit-taking institutions, rather than serving Italian clients mainly from San Marino as they currently do.

POLICY DISCUSSIONS

A. Financial Sector

The Banking System

7. **Liquidity ratios appear adequate, but NPLs have surged to over 40 percent, putting pressure on capital buffers.** The ratio of liquid assets to short-term liabilities rose to 50 percent, from 30 percent in 2012. The recent Italian policy on voluntary disclosure of assets to the tax authorities—under which Italian citizens may have an incentive to repatriate offshore assets—has raised uncertainty about outflows of nonresident deposits. Still, the liquidity buffers should enable banks to withstand such withdrawals. Overall, the banking system's capital adequacy ratio stands at 12.7 percent, well above the 11 percent minimum capital ratio, although recently recapitalized Cassa di Risparmio della Repubblica di San Marino (CRSM) still falls short with an estimated capital ratio of 7.5 percent. However, NPLs spiked by €932 million to 42 percent of total loans in the year to June 2014, from 22 percent a year earlier. Most of the increase, €876 million, was related to CRSM's recapitalization (see below), when loans from its restructured Delta subsidiary were restructured and brought on to its own balance sheet. Still, NPLs in the rest of the system

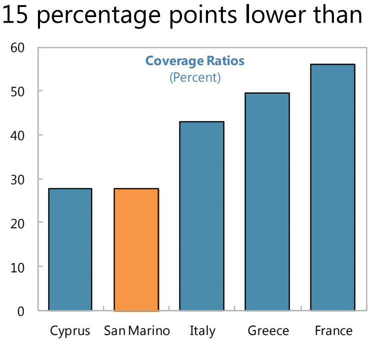
also rose significantly, in part due to strengthened enforcement of existing regulation. NPLs are concentrated in the household, construction, and service sectors and expected to remain elevated for a prolonged period of time even as the economy returns to modest growth. Since provisions did not keep up with the increase in NPLs, the coverage ratio dropped to 28 percent (33 percent for the system excluding CRSM). In the first half of 2014, losses in the banking system decreased by 20 percent year-over-year to €14 million (equivalent to 1 percent of GDP).

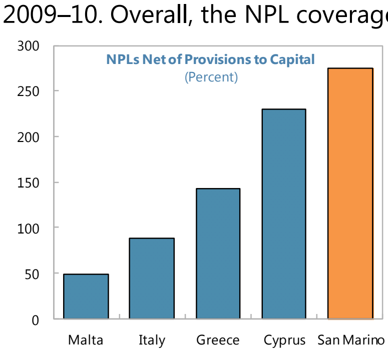
8. The weak asset quality raises concerns about the financial system, and may hinder economic growth. While a bank-by-bank asset quality review is needed to determine appropriate provision levels, the current level of 28 percent appears low both by historical standards (provisions stood at 44 percent on average in 2009–10) and compared with peer countries (Box 1). Underprovisioning of NPLs raises several issues. First, it taints the reliability of capital measures, as full recognition of expected losses on NPLs would negatively impact capital. This has happened already at CRSM in the recapitalization process, while at several other banks, the need to take additional provisions has affected profits. Second, banks' incentives to sell NPLs remain weak, as such sales would result in large book losses. Third, it may reduce credit supply and limit economic adjustment if banks keep underperforming firms that are not able to repay their loans from restructuring. Lastly, forbearance with respect to provisioning may ultimately increase losses, as no action towards a solution is taken.

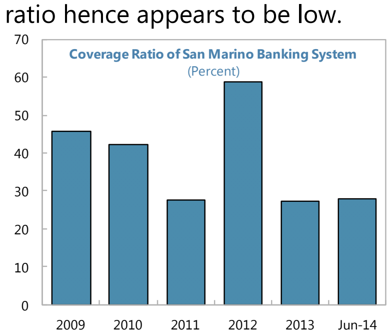
Box 1. San Marino's Banking System in International Perspective

With 470 percent of GDP in assets (€6.2 billion), the Sammarinese banking system is very large. However, it is much smaller than at the onset of the global financial crisis, when it accounted for 650 percent of GDP. In relative terms, it is close to Cyprus's (575 percent of GDP) but an order of magnitude smaller than Luxembourg's (about 2,000 percent of GDP). Overall, 40 percent of assets are claims on nonresidents. Two banks are more domestically oriented, with about 70 percent of domestic loans in their portfolio. On the funding side, 75 percent of deposits are from residents. Most banks are domestically owned.

At 28 percent, the coverage ratio of NPLs is relatively low by international standards. San Marino's ratio is significantly below most other European countries'. While the system's capital ratio exceeds the required level, NPLs net of provisions are very large relative to capital. Thus, higher-than-expected losses on NPLs could quickly erode capital buffers. International comparisons should be interpreted with caution, though, since restructured Delta loans on CRSM's balance sheet account for 35 percent of system NPLs. Excluding restructured loans—which can be expected to yield relatively high recovery and hence feature relatively low provisioning rates—the coverage ratio is 42 percent. For the bad loan portfolio—the worst category of NPLs—coverage is significantly higher at 57 percent. In historical perspective, coverage is about 15 percentage points lower than in 2009–10. Overall, the NPL coverage ratio hence appears to be low.







Sources: Central Bank of San Marino and IMF FSIs.
1/ Partly reflecting CRSM provisions taken in 2012 to cover NPLs recognized in 2013.

9. The authorities should come up with a plan to deal with low coverage ratios and potential capital shortfalls in the banking system. Failure to do so may exacerbate losses going forward and depress credit supply. Such a plan should include the following steps:

- *Asset quality review (AQR)*. An AQR is critical to reduce uncertainty by establishing a clear baseline, based on accurate loan classification, collateral valuations, and bank-by-bank assessments of expected losses and provisioning levels. These AQRs should build on the Central Bank of San Marino's (CBSM) ongoing on-site supervisory bank inspections. In case of capacity constraints, the authorities should consider hiring external parties to perform the AQRs.

- *Provisioning*. The CBSM should encourage banks to raise their provisions ahead of the AQR results. Once the AQR has been completed, the CBSM should demand banks bring provisions up to the needed level, while strict on-site supervision should ensure compliance with provisioning rules going forward. The CBSM should also gradually introduce more stringent provisioning requirements to ensure adequate provisioning levels in the future.

- *Capitalization*. Higher provisions could result in capital shortfalls. Banks with capital shortfalls should retain their earnings to increase capital. Banks where retained earnings would not quickly close the gap should be given a limited amount of time to present market-based recapitalization plans to the central bank, and another time limit to execute them.

- *Resolution*. Banks that remain critically undercapitalized should be resolved. Banks deemed systemically important should be recapitalized according to best international practices, including full unconditionally and upfront dilution of existing shareholders.

10. Foreign investment could support recapitalization efforts, but high standards should apply to investors. In particular, the authorities should carefully examine the business plans of potential foreign investors and apply best-practice fit and proper standards.

11. It is essential to address the large stock of NPLs, by escalating collection efforts and exploring sales of bad assets. Banks should pursue collection of bad loans aggressively. For some banks, setting up special purpose vehicles to host NPLs or the outright sale of part of their NPL portfolios could aid this process. In case banks lack specific collection expertise, the authorities could encourage banks to set up modalities to share such expertise (e.g., through joint training). Furthermore, the limit on tax deductibility of provisions should be raised from its current level of 5 percent of loans per annum, as it disincentivizes provisioning.

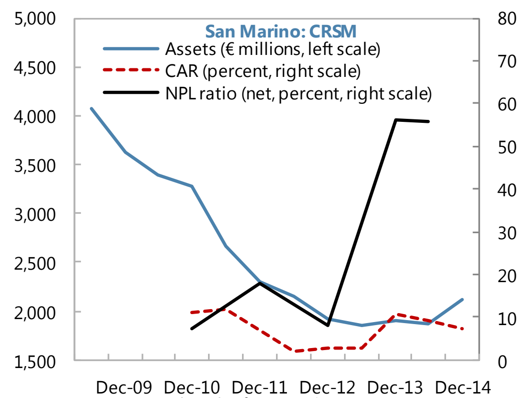
12. The plan to adopt Basel III is welcome, and there is scope to improve the supervision and resolution framework. The authorities are preparing a timeline to guide the adoption of Basel III standards by 2017. This process will allow for continued improvements in the supervisory framework, which should pay special attention to liquidity buffers, ensuring they continue to be large enough to withstand sizeable outflows of nonresident deposits. The bank resolution framework should be adapted to improve the deposit insurance system and to put speedy and least-cost resolution of failed banks at its core, amending the banking law to introduce a special bank resolution regime.

13. The role of the central bank is central to many of these recommendations. In order to deliver on the above plan on provisioning, work on the implementation of Basel III, and more generally deal with its growing set of responsibilities, the CBSM needs additional resources and independence in their deployment. Furthermore, the role of the CBSM in both the operation and supervision of pension funds needs to be reviewed to avoid conflicts of interest. Constraints on hiring foreign experts to deal with bank restructuring should be reconsidered.

Cassa di Risparmio

14. CRSM was recapitalized, but modalities did not follow best-practice. The bank has required a total of 13 percent of GDP in public support during 2012–14, with the last recapitalization agreement implemented in April 2014.[1] This was due mainly to large losses on its investment in the Italian Delta group, which was intervened by Italian supervisors and put under compulsory administration. The 2013–14 recapitalization was a necessary step and introduced partial dilution of shareholders. However, the shareholders were not fully and unconditionally diluted, but instead kept a majority equity stake. And while the state now gets to nominate a majority of the banks' board members, the foundation (CRSM's majority shareholder) still nominates a minority of board members and has to approve any sale of the state's shares in the bank.

15. The bank's turnaround remains incomplete, amid continuing operational losses. Even after recapitalization, at end 2014 CRSM's capital ratio is only 7.5 percent, €51 million short of the minimum regulatory capital. This shortfall is significantly worse than envisaged in the original recapitalization plan. Moreover, the bank continues to make losses (€31 million in 2014, compared to €36 million in 2013 and €156 million in 2012) and its provisions cover just a quarter of NPLs.



Source: Central Bank of San Marino

16. To limit the risk of further public support, it is important to speed up CRSM's restructuring and improve its governance. The authorities should demand a business plan from CRSM that shows how, under a realistic but conservative scenario, the bank will become profitable and reach the minimum capital requirement within three years. Significant cost cuts and reducing the size of the balance sheet further should be part of the strategy. Adverse contingency plans should be drafted, to be prepared in case the business plan proves unsuccessful. The state should

[1] The agreement was negotiated in 2013 and discussed in last year's staff report (IMF Country Report 14/104).

promptly appoint seasoned turnaround experts to CRSM's board and executive positions. To facilitate this, revisions to the recapitalization agreement between the foundation and the state should be considered to give the state complete ownership and control of CRSM. Without these actions, the risk that CRSM will require further public support in the future is considerable.

Authorities' views

17. The authorities noted that the financial system as a whole is transitioning to a new business model and that on-site bank inspections are ongoing. They thought that better relations with Italy will soon allow Sammarinese banks to operate in Italy as deposit-taking institutions, thus creating opportunities for growth. Still, they recognized this strategy remains untested. The authorities contended that judging the adequate level of provisions should depend on the composition of the NPL portfolio. In particular, a large share of NPLs concerns leasing assets, where banks own the underlying asset. They also noted that restructured Delta loans in CRSM account for a large share of total NPLs, and that, as these loans have already been restructured, their recovery rate is expected to be higher. Nonetheless, the authorities agreed on the need for AQRs for the largest banks, which the CBSM is conducting as part of its ongoing on-site inspection program.

18. On CRSM, the authorities saw getting the bank back to health as the most important challenge. They emphasized the successful recapitalization that took place last year, while acknowledging modalities deviated from best practice. Looking forward, they will carefully review the business plan CRSM recently submitted to ensure its viability.

B. Public Finances

19. The central government deficit is expected to decline slightly to 1.1 percent of GDP in 2014. After peaking at 4.1 percent of GDP in 2011, fiscal consolidation brought the deficit down to a more manageable level of 1.5 percent of GDP in 2013. The 2014 income tax reform adjusted tax brackets and reduced exemptions. Together with the introduction of an electronic certification system to enhance collection, 2014 tax revenue is projected to have increased by almost 1½ percent of GDP to 17 percent of GDP. At the same time, reining in the public sector wage bill helped contain expenditure growth. However, some of the improvement in the central government balance reflects cuts in transfers to the social security fund. Between 2012 and 2014, these transfers declined by €14 million, while the fund's operational deficit increased by €16.5 million to €27 million (2 percent of GDP).

20. The 2015 budget preserves the consolidation efforts based on modest further efficiency gains. The authorities plan to reduce expenditure on the public administration by a further 0.2 percent of GDP, principally by reducing allowances and overtime, merging public offices, encouraging early retirement, and more generally reviewing the number of employees. Tax revenue is projected to remain stable, while expenditure on transfers to social security and interest payments are projected to increase. However, capital expenditure is expected to fall, leaving the overall balance unchanged at -1.1 percent of GDP.

21. Debt is on an upward path, projected to reach 27 percent of GDP by 2020 under a scenario without policy change. A comprehensive reassessment of outstanding tax refunds led to a sharp decrease in net accounts payable in 2011–12, revising public debt down by almost 7 percent of GDP. However, successive recapitalizations of CRSM together with budget deficits increased public debt to 23 percent of GDP at end 2014, up from 11 percent in 2007. Over the same period, government deposits decreased from 12 to 3 percent of GDP. Going forward, debt is projected to gradually increase further on moderate fiscal deficits amidst modest economic growth. Debt is mostly financed by domestic bank loans and the CRSM recapitalization bond. San Marino has not issued bonds on the international capital market.

22. Rebuilding the buffers that served San Marino well during the crisis remains paramount. Fiscal adjustment of 2½ percent in discretionary measures at the central government level, realized over five years, would put debt on a downward path. The adjustment should start in 2016, once the recovery is firmly underway, but credible plans should be announced as early as possible. Plans should be skewed towards expenditure cuts, in recognition of San Marino's new post-crisis economic realities in which output declined by a third and hence spending as a share of GDP increased markedly compared to 2008. However, such expenditure cuts should not result in increased deficits in the social security fund. Under such a fiscal stance, the government would have sufficient fiscal buffers to withstand a contingent shock (e.g., from further bank recapitalization needs) in the magnitude of 20 percent of GDP, with debt still peaking below 50 percent of GDP (Annex II). Over the medium term, parametric reform of social security is needed to ensure its sustainability. Without it, social security balances will run down fast amid pressure to increase transfers from the central government.

23. Expenditure policy should center on curtailing the public sector wage bill, public pensions, and health benefits. A recent expenditure review suggested measures should target the public sector wage bill—both through wages (which remain some 10 percent above those in the private sector) and employment—the public pension system, and health care benefits. Such policies would reduce deficits both at the central government level as well as in the social security fund. The measures could yield some 2 percent of GDP, creating space for well-targeted increases of around ½ percent of GDP in capital spending, which has been reduced to unsustainably low levels over the last few years. Private sector participation in capital spending could be explored, as long as modalities provide real risk sharing and limit contingent liabilities.

24. The planned introduction of the VAT is welcome and efforts should be made to find additional revenue sources. In particular, a real estate tax yielding about 1 percent of GDP would provide an equitable and efficient source of income. Alternatively, raising the VAT rate above its planned level could be considered. The decision on the actual rate should be informed by an analysis of projected VAT revenue and its sensitivity to the VAT rate. Exemptions from the standard VAT rate should be limited to a narrow set of basic goods. An increase of the corporate tax rate is not advisable, as it would negatively affect competitiveness.

25. Establishing market access for the sovereign would help diversify funding sources. Even if more expensive than domestic borrowing, market access provides a crucial buffer in the event of shocks that simultaneously raise borrowing needs and leave domestic banks unable to lend to the government. Accessing the markets for the first time could involve non-negligible costs but the current international financial environment could prove attractive for issuance.

Authorities' views

26. The authorities agreed with the importance of rebuilding fiscal buffers to cushion the impact of future shocks. In this regard, they plan to continue to curb current expenditure and reduce the deficit. This will create room for planned additional capital expenditure relating to infrastructure and a high-tech business incubator. They also saw the need for policy action to make pension liabilities sustainable. On revenues, the authorities did not believe reinstating a real estate tax is feasible and note that a higher VAT would have inflationary effects. With respect to accessing international markets, the authorities agreed on the possible benefits and noted that they are investigating various avenues for financing.

C. Structural Policies and International Cooperation

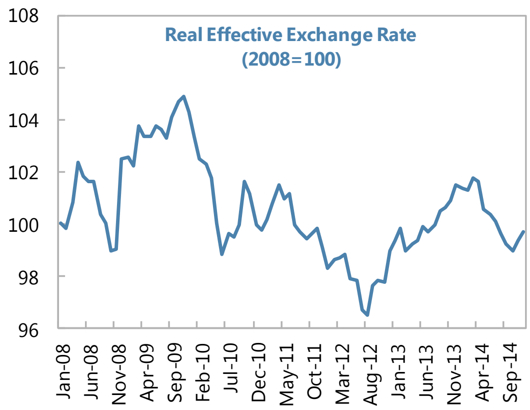
27. Recent improvements in the business environment and government policies support development of the nonbanking sector. The new simple and fast online process to establish a business and ongoing effort to simplify the registration of property should boost investment and economic activity. Once up and running, the new credit registry would facilitate access to credit. Other recent welcome government initiatives include setting up a high-tech business incubator and starting talks with Italy to allow Sammarinese companies to operate business aviation and cargo services at a nearby Italian airport. Nevertheless, it remains important to perform careful cost-benefit analysis of the incentives and tax breaks involved in such projects.

28. Changes to labor market policies and vocational training should further support employment and growth. Recently introduced incentives for employment include the establishment of entry-level wages below the lowest level in collective wage agreements, and temporary lower social security contributions when hiring unemployed workers. Further reform of the labor market, culminating in changes to the labor law, is under discussion. The process to hire nonresidents remains slow and complicated, and in practice results in hiring caps. Recent exemptions from this process for high-tech business in the incubator may provide a model for the broader economy, allowing San Marino to take greater advantage of the labor market in Emilia-Romagna, the dynamic neighboring Italian region. Unemployed workers are provided with vocational training, in order to diminish existing skills gaps. To increase the productivity of the labor force further, worker education and vocational training could be employed more broadly.

29. An inflation differential and a wage gap with Italy suggest price competitiveness may be an issue. A proxy[2] for San Marino's real effective exchange rate (REER) has fallen back to

[2] Italy's REER corrected for differences in developments in the consumer price index for Italy and San Marino.

early 2008 levels, but the inflation differential with Italy continues on a gradual upward trend. Together with a 12 percent wage gap with Italy, this suggests San Marino's REER may be overvalued. The recommended structural and fiscal policies should serve to close this gap over time.



Source: IFS.

Sources: Sammarinese authorities; and IMF staff estimates.
1/ Average of four industrial sectors.
2/ A posititive number means Sammarinese wages are higher than Italian wages.

30. International cooperation improved significantly and continued commitment in this area remains crucial for a very small open economy like San Marino. Most importantly, towards end 2014, Italy included San Marino in its tax whitelist and the bilateral economic cooperation agreement was concluded. Looking forward, the prompt conclusion of the memorandum of understanding (MoU) with the Bank of Italy that will allow the uninterrupted payment card services and may fully open the Italian banking market for Sammarinese banks is a priority. In this regard, the ongoing setup of the credit register is very important. Moreover, San Marino—together with Andorra and Monaco—has started negotiations on an association agreement with the EU, focused on fully integrating the country with the EU's four freedoms.

31. The imminent launch of a national AML/CFT risk assessment is commendable. The authorities are also preparing to be among the early adopters of the OECD initiative for exchange of tax information (to be launched in 2017 following the FATCA model). Together with MONEYVAL's recognition of San Marino's anti-money laundering efforts, these actions will contribute to further shedding the perception of San Marino as an offshore haven.

Authorities' views

32. The authorities agreed that San Marino has to diversify its economy and find a new growth model and saw their focus on international cooperation as key. They pointed to the various initiatives underway including the high-tech business incubator, a science park, and various efforts to boost tourism revenue and infrastructure more generally. The authorities are committed to simplifying bureaucracy and improving the business environment in order to both attract foreign direct investment and improve productivity for existing companies. They explained the wage cost differential with Italy is smaller than implied by the data, as wages in neighboring Italian regions are significantly above the Italian national average numbers. They are moving forward with the technical setup of the credit register, and have amended the banking law to allow for reciprocal international credit information exchange. This should allow negotiations on the MoU with the Bank of Italy to proceed, with the aim of concluding soon. Ultimately, the EU association agreement is seen as taking the country to its goal of full integration of all sectors of the Sammarinese economy into the EU single market.

D. Data Issues

33. Data provision is broadly adequate for surveillance purposes, but gaps exist. While these data gaps are not uncommon for a small country like San Marino, there is a need to improve timeliness of, in particular, national accounts and fiscal statistics and ensure consistency with international standards. Balance of payments data are not currently available, but San Marino is working with specialized IMF staff to start the compilation of these data. Importantly, banking sector data are comprehensive and timely.

STAFF APPRAISAL

34. Over the last year, San Marino has made very significant progress normalizing international relations and it is set to emerge from a deep recession. On the back of the inclusion in Italy's tax whitelist and the conclusion of bilateral financial and economic cooperation agreements, there are signs that the economy is stabilizing. Staff expects GDP to expand by 1 percent this year, followed by modest growth over the medium term. Nevertheless, the output loss during the crisis has been very large, and it will take a long time for GDP to return to its pre-crisis level.

35. Still, serious policy challenges remain. Liquidity conditions in the banking system improved and steps were taken in an attempt to put CRSM on sound footing. Yet, issues remain with respect to CRSM and high NPLs in the banking system more broadly.

36. CRSM needs a strong and credible business plan to minimize the risk of further public support. The plan should show how the bank will become profitable and reach the minimum capital requirement within three years. Its baseline should be based on realistic, but conservative assumptions and a contingency plan "Plan B" should spell out what will be done in case the business plan is unsuccessful. As a matter of urgency, seasoned experts to engineer a turnaround should be appointed to CRSM's board and executive positions. Moreover, revisions to the recapitalization agreement between the foundation and the state to give the state complete ownership and control of CRSM should be considered.

37. Banks need to deal with their very large NPL portfolios in order to be able to support the recovery. They should enhance their NPL collection efforts and increase NPL provisioning. The following steps are needed to assert asset quality and increase provisions:

- First, a bank-by-bank asset quality review, building on the CBSM's ongoing bank inspections, is needed to ascertain the quality of banks' loan portfolios. The support of external parties should be considered.

- Second and in parallel with the first step, the CBSM should continue to encourage banks to increase provisions immediately since they are low by international and historical standards. Stricter on-site supervision should ensure adequate provisioning going forward.

- A third step would be needed if the exercise indicates capital shortfalls. Market-based recapitalization plans would have to be presented to the CBSM. If such plans fail, banks that remained critically undercapitalized would have to be resolved. In the case of systemic banks, public support may be inevitable.

38. The Central Bank will have to play a central role in this process. In order to deliver on the plan above and deal with its growing set of responsibilities, the CBSM needs additional resources and independence in their deployment.

39. Further fiscal effort is needed to rebuild the buffers San Marino had before the crisis. Without these buffers, the crisis would have been even deeper and the state could not have cushioned social expenditure. The central government's fiscal position has worsened as tax receipts declined, but efforts over the last two years to reduce the deficit represent important steps in the right direction. Furthermore, the balance of the social security institute has deteriorated significantly. To strengthen the fiscal balance further, the authorities should design a multi-year strategy, with implementation starting in 2016 once the economy is solidly growing again.

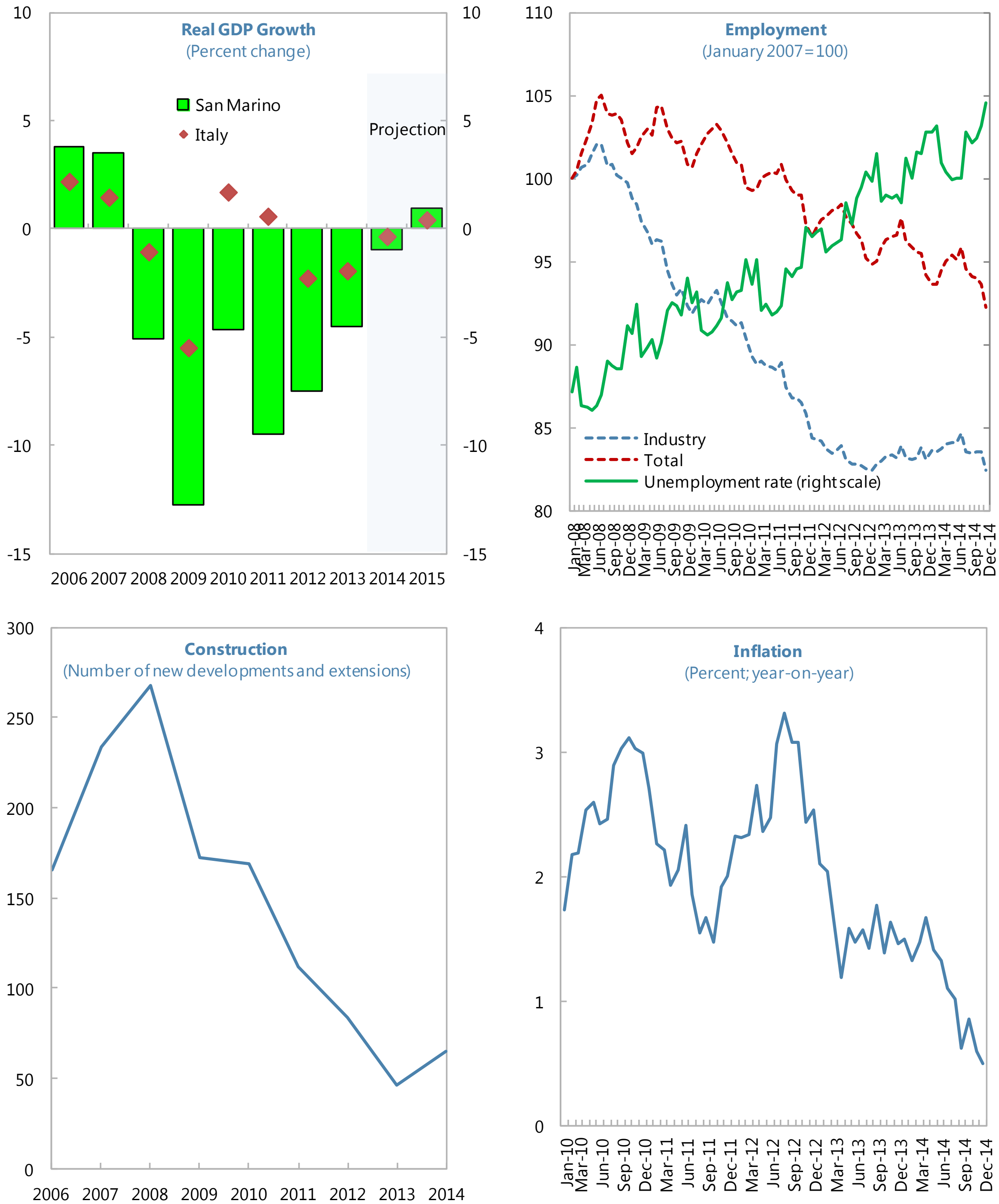
40. The fiscal strategy should aim to lower overall expenditure, while modestly increasing tax revenue. Overall, 2½ percent of GDP in measures over five years are needed to start rebuilding buffers. Areas for action identified by a recent spending review include the public sector wage bill, pensions, and health costs. A real estate tax would be the optimal choice to increase tax revenue, as it provides an equitable and efficient source of income. Alternatively, a slight increase in the envisaged VAT rate could be considered. This fiscal strategy would also create space for the authorities' planned timely increase in capital spending. Still, over the medium term, parametric reform of social security is needed to ensure its sustainability. The authorities should also consider modest borrowing in international capital markets, as establishing market access would provide an important additional buffer to deal with shocks.

41. San Marino has recently achieved very important milestones in international cooperation. The inclusion in Italy's tax whitelist is a key step, as is MONEYVAL's report on anti-money laundering efforts. Continued international cooperation building on these achievements is essential for a new growth model to emerge. Priority should be given to concluding the MoU with the Bank of Italy in the near term. Negotiating an association agreement with the EU is a key medium-term priority.

42. Recent improvements in the business environment are a welcome development. Efforts to speed up the process of starting a business and simplify the registration of property should support economic activity. Completion of the ongoing work to create a credit registry will improve access to credit. Government initiatives such as the high-tech incubator are positive as long as their fiscal costs are monitored closely.

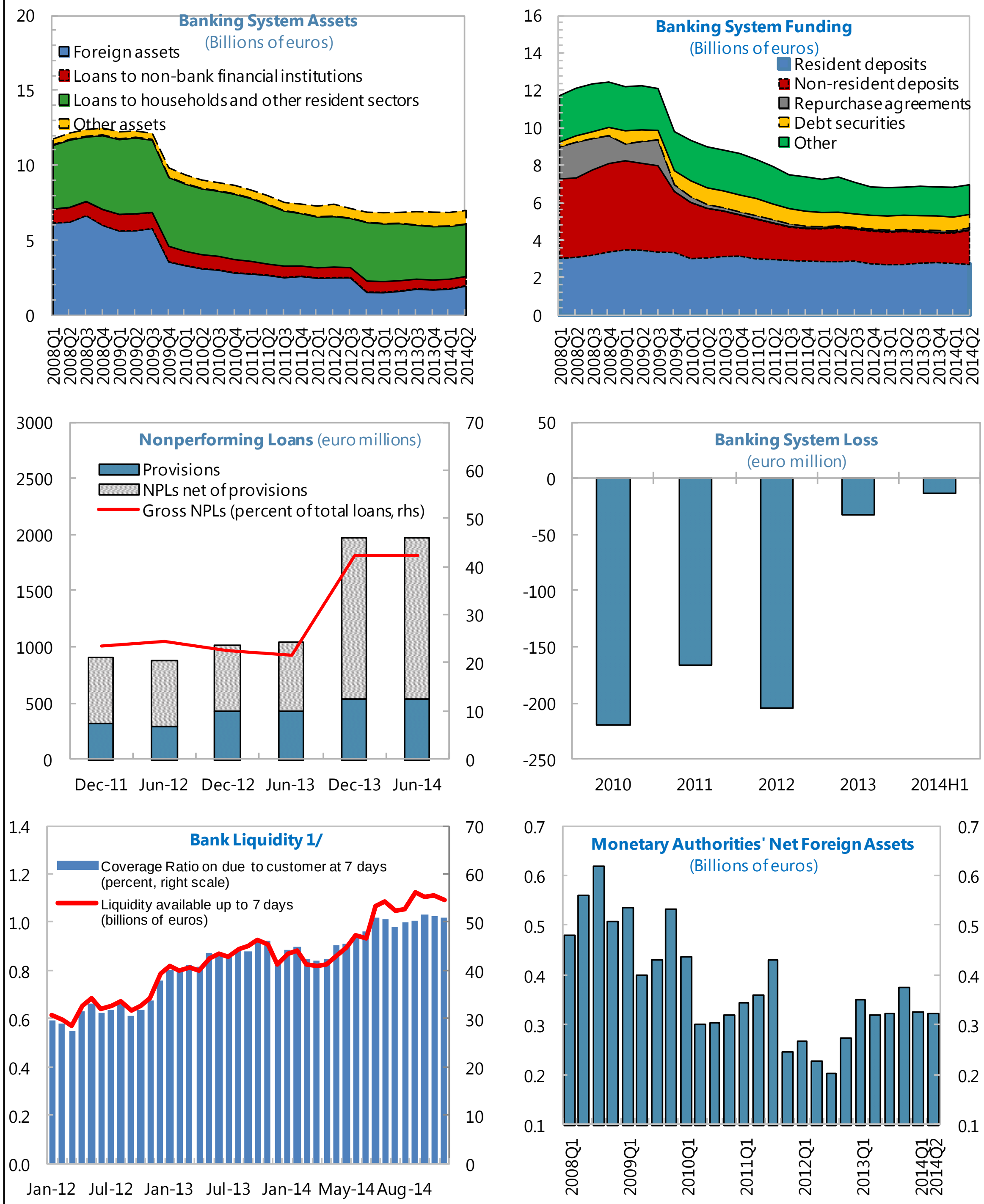
43. It is recommended that the next Article IV consultation with the Republic of San Marino be held on the standard 12-month cycle.

Figure 1. San Marino: Recent Economic Developments, 2006-15



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

Figure 2. San Marino: Financial Sector Indicators, 2008-14



Sources: CBSM; IMF, International Financial Statistics; UPECEDS; and IMF staff calculations.
1/ Liquid assets as a share of liquid liabilities, excluding inter-bank loans.

Table 1. San Marino: Selected Economic and Social Indicators, 2012-16

GDP per capita (2013): 56,112 U.S. dollars
Population (December 2013): 31,460 persons

Life expectancy at birth (2010): 83.2 years
Literacy, adult (2008): 96 percent

			Projection		
	2012	2013	2014	2015	2016
Activity and Prices					
Real GDP (percent change)	-7.5	-4.5	-1.0	1.0	1.1
Domestic demand	-4.6	-2.9	...	...	...
Final consumption	0.0	-1.4	...	...	...
Fixed investment	-13.0	-8.4	...	...	...
Net exports (contribution to growth)	-4.1	-2.3	...	...	...
Exports	-9.8	-6.6	...	...	...
Imports	-8.9	-6.1	...	...	...
Employment (percent change)	-2.6	-1.3	-0.8	...	...
Unemployment rate (average; percent)	6.9	8.1	8.7	...	...
Inflation rate (average; percent)	2.8	1.3	1.1	0.4	0.9
Nominal GDP (millions of euros)	1401.5	1357.1	1343.5	1363.3	1392.1
Public Finances (percent of GDP) 1/					
Revenues	20.4	20.3	22.1	21.5	21.5
Expenditure	23.0	21.8	23.2	22.7	22.8
Overall balance	-2.6	-1.5	-1.1	-1.1	-1.2
Government debt	15.4	21.6	22.9	23.7	24.4
Loans	7.1	14.3	14.9	15.8	16.7
Net account payables	8.3	7.3	8.0	7.9	7.8
Government deposits (millions of euros)	72.9	55.9	40.4	45.0	45.0
Money and Credit					
Deposits (percent change)	-6.3	-6.5	...	...	...
Private sector credit (percent change)	11.4	-8.7	...	...	...
Net foreign assets (percent of GDP)	38.4	47.1	...	...	...
Commercial banks	21.9	31.8	...	...	...
Central bank	16.5	15.2	...	...	...
External Accounts (percent of GDP)					
Balance of goods and services	21.6	21.7	...	...	...
Exports	178.7	171.4	...	...	...
Imports	157.1	149.7	...	...	...
Gross international reserves (millions of U.S. dollars)	308.6	539.3	...	...	...
Exchange Rate (average)					
Euros per U.S. dollar	0.78	0.75	0.75	...	...
Real exchange rate vis-à-vis Italy	98.0	100.0	...	...	...
Financial Soundness Indicators (percent) 2/					
Regulatory capital to risk-weighted assets	8.8	13.6	13.0	...	...
Bad loans to total loans	9.6	13.9	15.3	...	...
Loan loss provision to total loans 3/	13.3	11.5	11.8	...	...
Return on equity (ROE)	-77.0	-7.5	...	...	...
Liquid assets to total assets	16.1	15.3	16.5	...	...
Liquid assets to short-term liabilities	31.7	42.8	46.6	...	...

Sources: International Financial Statistics; Sammarinese authorities; World Bank; and IMF staff calculations.
1/ For the central government. Does not include possible costs of future bank recapitalization.
2/ For 2014, latest available.
3/ Based on total loan loss provision, which covers nonperforming and performing loans.

Table 2. San Marino: Financial Soundness Indicators, 2009–14

	2009	2010	2011	2012	2013	Jun-14
Capital adequacy ratios (percent)						
Regulatory capital to risk-weighted assets	16.9	15.6	14.1	8.8	13.6	13.0
Capital to assets	11.1	9.9	9.6	8.2	9.4	8.5
Asset quality ratios (percent)						
Bad loans to total loans	2.9	5.9	7.2	9.6	13.9	15.3
Nonperforming loans to total loans	8.5	15.0	34.1	20.4	42.3	42.3
Bad loans net of provision to capital	7.2	17.6	28.7	41.3	47.3	59.1
Nonperforming loans net of provision to capital	22.9	52.5	205.8	82.4	249.1	274.3
Coverage ratio	45.7	42.3	27.7	58.8	27.1	27.8
Earning and profitability (percent)						
Return on assets (ROA) 1/	-1.4	-2.7	-6.6	-10.9	-1.5	...
Return on assets (ROA) 2/	-1.6	-2.6	-2.4	-6.9	-0.7	...
Return on equity (ROE) 1/	-13.1	-25.2	-67.9	-121.5	-15.8	...
Return on equity (ROE) 2/	-14.4	-24.4	-24.4	-77.0	-7.5	...
Interest margin to gross income	51.4	49.0	65.8	51.9	42.2	...
Non-interest expenses to gross income	52.2	68.5	83.2	88.7	114.3	...
Trading income to gross income	11.0	1.3	-7.0	8.7	8.4	...
Administrative expenses to non-interest expenditures	51.3	61.9	69.2	69.7	66.1	...
Liquidity (percent)						
Liquid assets to total assets	25.5	17.1	15.0	16.1	15.3	16.5
Liquid assets to short-term liabilities	...	...	...	31.7	42.8	46.6
Loans to deposits	88.5	101.4	91.6	108.7	109.0	86.4

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

1/ Before extraordinary items and taxes.

2/ After extraordinary items and taxes, and before provision to fund for general banking risk.

Table 3. San Marino: Statement of Operations for Budgetary Central Government, 2009–16
(Percent of GDP)

						Projection		
	2009	2010	2011	2012	2013	2014	2015	2016
Revenue	19.1	19.0	18.3	20.4	20.3	22.1	21.5	21.5
Taxes	14.5	14.2	13.0	14.6	15.1	16.6	16.6	16.6
Income Taxes	7.1	7.5	7.1	7.0	7.7	8.0	7.9	7.9
Non-income taxes 1/	7.3	6.7	5.9	7.6	7.4	8.6	8.6	8.6
Taxes on international trade and transactions	4.4	4.0	3.5	4.5	5.3	6.3	6.4	6.4
Other taxes	2.9	2.7	2.5	3.0	2.2	2.2	2.2	2.2
Non-tax revenue	4.6	4.8	5.3	5.8	5.2	5.6	5.0	5.0
Expenditure	21.7	21.4	22.4	23.0	21.8	23.2	22.7	22.8
Current Expenditure	18.1	18.9	19.8	20.7	20.4	20.7	21.0	21.1
Compensation of employees	6.8	7.3	7.7	8.0	8.3	8.0	7.9	7.9
Use of goods and services	1.8	1.8	2.0	2.1	2.0	2.5	2.3	2.3
Interest	0.1	0.1	0.1	0.1	0.1	0.3	0.3	0.4
Transfers	9.2	9.4	9.7	10.2	9.8	9.5	10.0	10.1
To other general government units	8.4	8.7	8.7	9.4	9.1	8.8	9.3	9.4
Other expenses (including subsidies)	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4
Capital Expense	3.5	2.6	2.6	2.2	1.4	2.5	1.6	1.6
Net lending (+)/borrowing (-) (fiscal balance)	-2.6	-2.4	-4.1	-2.6	-1.5	-1.1	-1.1	-1.2
Memorandum items								
Social Seurity balance	...	...	-0.2	-0.8	-0.8	-2.0	...	...
Public debt	17.5	17.5	14.7	15.4	21.6	22.9	23.7	24.4
Loans	3.7	3.4	3.2	7.1	14.3	14.9	15.8	16.7
Net accounts payable	13.8	14.1	11.5	8.3	7.3	8.0	7.9	7.8
Government deposits	15.1	13.5	10.4	5.2	4.1	3.0	3.3	3.2
Nominal GDP (in millions of euros)	1700.8	1615.3	1477.5	1401.5	1357.1	1343.5	1363.3	1392.1

Sources: Sammarinese authorities; and IMF staff calculations and projections.

1/ Does not reflect the introduction of the VAT, planned for 2016.

Appendix I. Risk Assessment Matrix[1]

Risk	Relative likelihood	Impact if realized	Policy Response
Protracted period of slower growth in advanced economies, and Italy and the Euro area in particular. Lower-than-anticipated potential growth and persistently low inflation due to a failure to fully address the legacies of the financial crisis, leading to secular stagnation and lower commodity prices.	**High**	**High** Given extensive financial and real links with Italy and advanced Europe, the impact on the Sammarinese economy would be large and direct.	• Let automatic stabilizers work. • Postpone fiscal adjustment. Reevaluate periodically.
Higher medium-term growth from inclusion in Italy's tax whitelist.	**Medium**	**Medium** The industrial and service sectors could bounce back, boosting growth, tax revenue, and banks' margins.	• Stick to reform plans despite upside.
A surge in global financial volatility, as investors reassess underlying risk.	**High**	**Low** The banking system is not active on the international capital markets and does not rely on wholesale funding.	• Intensify supervisory dialogue with the banks. • Strengthen public communication.
Further modest public bank recaps.	**High**	**Medium** Public finances could cope with modest further bank recapitalization needs.	• Accelerate establishment of market access for the sovereign. • Accelerate AQRs. • Prepare adjustment/ contingency plans, based on AQR results.
Failure to clean up bank balance sheets, leading to a loss of confidence in the system.	**Medium**	**High** A loss of confidence in the system would likely lead to large public recapitalization needs and would have significant growth and fiscal implications.	

[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 of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of the risks and overall level of concern as of the time of the discussion with the authorities.

Failure to enact fiscal consolidation.	**Medium**	**Medium** Public debt would remain on an upward trend, and there would be limited fiscal space to absorb further shocks from the financial system.	• Establish credible medium-term fiscal framework. • Cut expenditure more than in baseline.
Tensions with neighboring Italy resurface.	**Low**	**High** Persistent tensions would dissuade some Italian corporates and banks from doing business with San Marino, thus affecting growth.	• Enhance focus on international relations. • Work towards early adoption of OECD initiative for exchange of tax information.

Appendix II. Public Sector Debt Sustainability

1. San Marino's central government debt is on an upward trajectory. Before the crisis, gross debt was mostly in the form of unclaimed tax refunds and stood below 15 percent of GDP. Net debt was negative, as the government held cash buffers slightly in excess of gross debt. However, the sharp decline in revenues triggered by the crisis swung budget surpluses into deficits. In addition, financial support to the largest bank amounting to 13 percent of GDP[1] increased debt to about 23 percent of GDP. Over the same timeframe, the government almost depleted its large cash buffers (cash buffers diminished to 3 percent of GDP in 2014). Based on current policies, the central government deficit is projected to remain around 1–1½ percent of GDP implying further increases in the debt to GDP ratio to 27 percent by 2020 (Figure A2.1).

2. The possible need for further bank capital support represents the main risk to public finances and debt sustainability. A shock scenario where further recapitalization needs amount to 20 percent of GDP—reflecting a combination of further capital for CRSM as well as other banks—would increase debt and, without a change in the fiscal stance, set it on an upward trajectory, reaching almost 50 percent of GDP by 2020. Such dynamics may prove unsustainable in a country without a track record of sovereign bond issuance and hence untested ability to access external financing.

3. These observations highlight the need for fiscal adjustment. Staff's suggested adjustment of 2½ percent of GDP would put debt on a downward trend—providing fiscal space for contingent liabilities (Figure A2.2). Accounting for such adjustment, debt would peak just below 45 percent of GDP in 2016 even after a 20 percent of GDP contingent shock.

[1] 11 percent was provided by the central government and 2 percent by the Social Security Institute.

Figure A2.1. San Marino: Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

(in percent of GDP unless otherwise indicated)

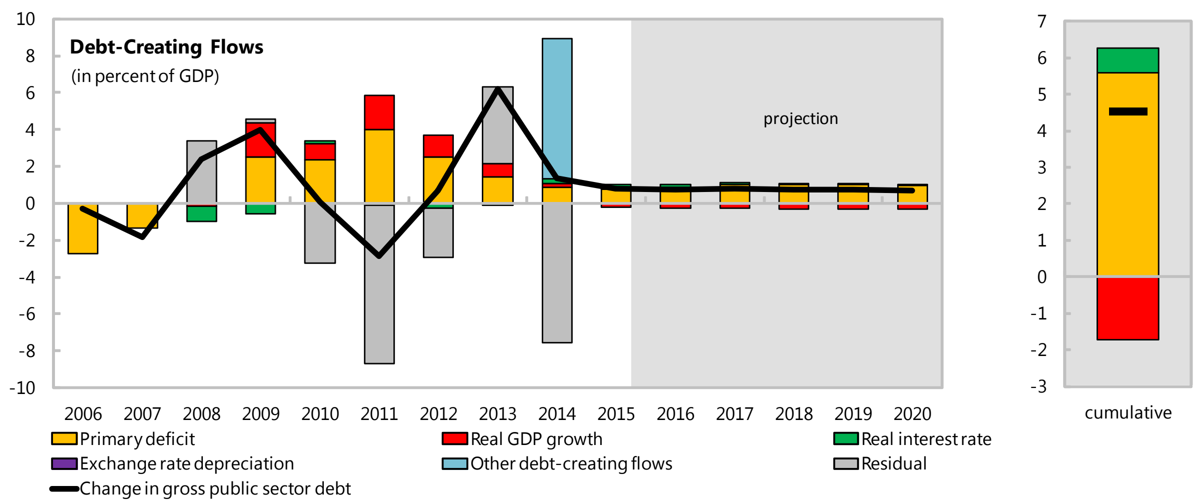
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020
Nominal gross public debt	12.9	21.6	22.9	23.7	24.4	25.2	26.0	26.7	27.4
Public gross financing needs	0.6	0.8	0.2	4.1	7.7	7.9	12.4	12.5	12.8
Real GDP growth (in percent)	-6.6	-4.5	-1.0	1.0	1.1	1.2	1.3	1.3	1.3
Inflation (GDP deflator, in percent)	4.6	1.4	0.0	0.5	1.0	1.3	1.5	1.6	1.7
Nominal GDP growth (in percent)	-0.7	-3.2	-1.0	1.5	2.1	2.5	2.8	2.9	3.0
Effective interest rate (in percent) [4/]	1.0	0.6	1.3	1.6	1.6	1.7	1.8	2.0	1.9

As of January 31, 2015		
Sovereign Spreads		
EMBIG (bp) 3/		n.a.
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.3	6.2	1.3	0.8	0.7	0.8	0.8	0.8	0.7	4.5	
Identified debt-creating flows	3.0	2.0	8.9	0.8	0.7	0.8	0.8	0.8	0.7	4.5	
Primary deficit	1.0	1.4	0.8	0.8	0.8	1.0	1.0	1.0	1.0	5.6	-0.3
Primary (noninterest) revenue and grants	19.4	20.3	22.1	21.5	21.5	21.5	21.5	21.5	21.5	129.2	
Primary (noninterest) expenditure	20.4	21.7	23.0	22.3	22.4	22.5	22.5	22.5	22.5	134.8	
Automatic debt dynamics [5/]	0.8	0.6	0.5	0.0	-0.1	-0.2	-0.2	-0.2	-0.3	-1.0	
Interest rate/growth differential [6/]	0.8	0.6	0.5	0.0	-0.1	-0.2	-0.2	-0.2	-0.3	-1.0	
Of which: real interest rate	-0.3	-0.1	0.3	0.2	0.1	0.1	0.1	0.1	0.0	0.7	
Of which: real GDP growth	1.1	0.7	0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-1.7	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	7.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	-2.2	4.2	-7.6	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



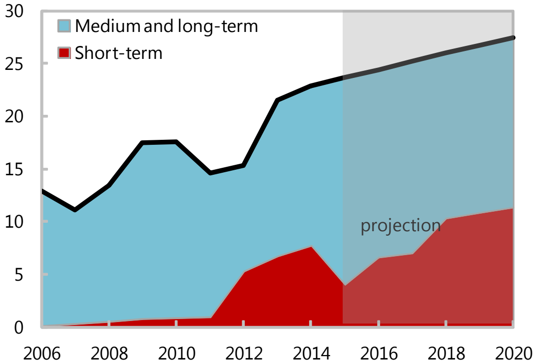
Source: IMF staff.
1/ Public sector is defined as central government.
2/ Based on available data.
3/ Long-term bond spread over German bonds.
4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.
5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.
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.

Figure A2.2. San Marino: Public Sector DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

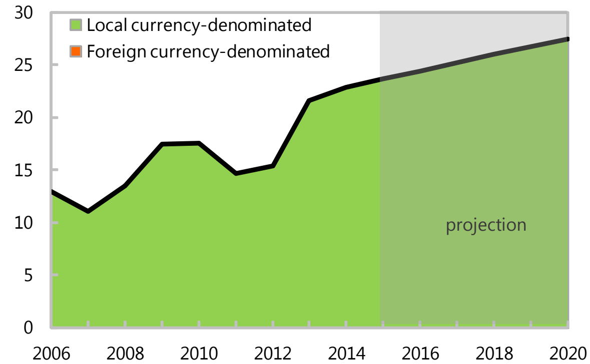
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



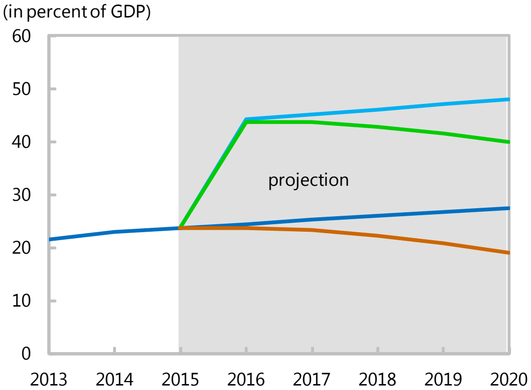
Alternative Scenarios

Baseline

Contingent Liability Shock   Contingent Liability Shock+Adj   Baseline+Adjustment

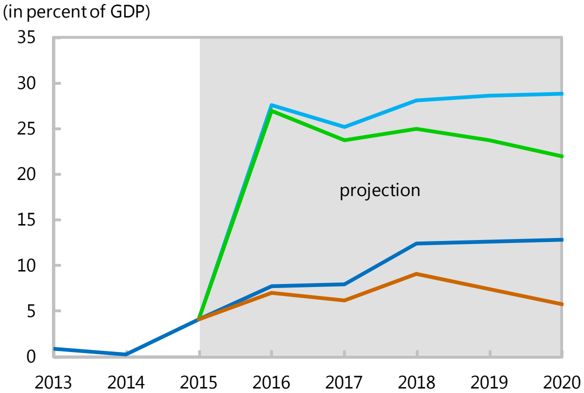
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

	2015	2016	2017	2018	2019	2020
Baseline Scenario						
Real GDP growth	1.0	1.1	1.2	1.3	1.3	1.3
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-0.8	-1.0	-1.0	-1.0	-1.0
Effective interest rate	1.6	1.6	1.7	1.8	2.0	1.9
Baseline+Adjustment						
Real GDP growth	1.0	1.1	1.2	1.3	1.3	1.3
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-0.3	0.0	0.7	1.2	1.5
Effective interest rate	1.6	0.5	1.4	1.3	1.8	1.7
Contingent Liability Shock						
Real GDP growth	1.0	1.1	1.2	1.3	1.3	1.3
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-20.8	-1.0	-1.0	-1.0	-1.0
Effective interest rate	1.6	0.6	2.5	2.6	2.8	2.9

	2015	2016	2017	2018	2019	2020
Contingent Liability Shock+Adj						
Real GDP growth	1.0	1.1	1.2	1.3	1.3	1.3
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-20.3	0.0	0.7	1.2	1.5
Effective interest rate	1.6	0.5	2.5	2.5	2.8	2.8
Historical Scenario						
Real GDP growth	1.0	-5.5	-5.5	-5.5	-5.5	-5.5
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-0.6	-0.6	-0.6	-0.6	-0.6
Effective interest rate	1.6	0.5	0.5	0.4	0.4	0.4
Constant Primary Balance Scenario						
Real GDP growth	1.0	1.1	1.2	1.3	1.3	1.3
Inflation	0.5	1.0	1.3	1.5	1.6	1.7
Primary Balance	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Effective interest rate	1.6	0.5	1.4	1.4	2.0	2.1

Source: IMF staff.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 6, 2015

Prepared By	European Department (In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of January 31, 2015)

Membership Status
Joined: September 23, 1992; Article VIII

General Resources Account	**SDR Million**	**Percent of Quota**
Quota	22.40	100.00
Fund holdings of currency	16.95	75.67
Reserves tranche position	5.45	24.34

SDR Department	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	15.53	100.00
Holdings	15.46	99.55

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to the Fund: None

Implementation of HIPC Initiative: Not applicable

Implementation of Multilateral Debt Relief Initiative: Not applicable

Implementation of Post-Catastrophe Debt Relief: Not applicable

Exchange 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 Central Bank of San Marino (CBSM). 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]

[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

(continued)

Article IV Consultation

San Marino is on a 12-month cycle. The previous Article IV consultation discussions took place during January 29–February 7, 2014, and the consultation was concluded on April 23, 2014 (IMF Country Report No. 14/104).

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

Resident Representative: None

Italy, acting on behalf of the European Union, or as a result of the monetary agreement signed between San Marino and the European Union.

STATISTICAL ISSUES

(As of February 26, 2015)

Data Provision

Data provision is broadly adequate for surveillance, but some data gaps exist. 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 March 2012, 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 level of 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 10 months delay. The authorities have also calculated sectoral contributions. As part of ongoing STA technical assistance on national accounts statistics, production and expenditure approaches are being adopted. Consumer prices and employment data are available monthly with short delays. 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 social security fund for 2004–14, as well as the budget for 2015. However, some of the data have not been compiled in accordance with IMF standards. Financing items, such as amortization, are included as expenditures while "borrowing requirement" is included among the revenues.

Monetary and Financial Statistics

Since 1997, the authorities have provided balance sheet data on the commercial banks and the monetary authorities to STA databases. 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 improved sectorization and 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 nonbank financial intermediaries are also lacking.

External Sector Statistics

Starting in 2008, trade statistics have been released quarterly with a lag of about six months.
San Marino does not publish balance of payments accounts, but the authorities have received Fund technical assistance on BOP statistics and are in the process of compiling them.

San Marino: Table of Common Indicators Required for Surveillance

(As of February 26, 2015)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange Rates	2/26/14	2/26/14	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Q2 2014	Jun 2014	Q	Q	Q
Reserve/Base Money	Q2 2014	Dec 2014	Q	Q	Q
Broad Money	Q2 2014	Dec 2014	Q	Q	Q
Central Bank Balance Sheet	Q2 2014	Dec 2014	Q	Q	Q
Consolidated Balance Sheet of the Banking System	Q2 2014	Dec 2014	Q	Q	Q
Interest Rates[2]	Q2 2014	Dec 2014	Q	Q	Q
Consumer Price Index	Dec 2014	Feb 2015	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2014	Jan 2015	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Q4 2014	Jan 2015	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	Q4 2014	Jan 2015	A	A	A
External Current Account Balance	NA [6]				
Exports and Imports of Goods and Services	2013	Nov 2014	A	A	A
GDP/GNP	2013	Nov 2014	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, domestic bank, 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] Lack of capacity precludes the compilation of balance of payments data at present. Fund technical assistance in this area is ongoing.

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April 8, 2015

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

IMF Executive Board Concludes 2015 Article IV Consultation with the Republic of San Marino

On March 25, 2015, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino.

Over the last five years, San Marino has weathered the implosion of its offshore banking system, the global crisis, and difficult relations with Italy. These shocks resulted in a loss of a third of output since 2008. Nonperforming loans in the banking system have risen to high levels, and the largest bank in the system has required 13 percent of GDP in public support.

The economy is now stabilizing, reflecting San Marino's improved relations with Italy and stable bank deposits. As a consequence, modest positive growth is expected this year. However, risks remain tilted to the downside, as the weak financial sector continues to cast a shadow over the medium-term outlook.

More needs to be done to ensure the banking system can support the recovery. The incomplete restructuring of the largest bank needs to be accelerated. The authorities should conduct in-depth asset quality assessments of the other banks, followed by plans to increase bank capital where needed.

Fiscal policy should aim at rebuilding the buffers that served San Marino well during the crisis. Gradual consolidation of 2½ percent of GDP over five years would be appropriate. Structural policies need to facilitate the reallocation of resources to the nonbanking sectors of the economy by further improving the business environment.

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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.

San Marino has recently achieved important milestones in international cooperation, including in the area of anti-money laundering. A continued focus in this area is essential for a new growth model to emerge.

Executive Board Assessment[2]

Executive Directors welcomed signs that the economy is stabilizing and the greatly improved international relations, but noted that challenges remain, particularly in the banking sector.

Directors noted the improving liquidity conditions in the banking system, but stressed the importance of dealing with the very large stock of nonperforming loans. They underscored that a plan including reviews of banks' asset quality, higher provisions, and contingency plans to deal with any capital shortfalls would help put the banking system in a position to support the economic recovery. In this context, Directors urged the authorities to accelerate the incomplete restructuring of Cassa di Risparmio della Repubblica di San Marino, improve its governance, and implement a strong and credible business plan to limit the risk of further public support.

Directors welcomed the authorities' initial progress toward rebuilding the fiscal buffers that served the country well in the past. They stressed, however, that additional measures over the medium term are needed. Directors recommended a strategy aimed at lower expenditure and modestly higher revenue. Expenditure policy should focus on curtailing the public sector wage bill, public pensions, and health benefits, while creating space for capital spending. Directors also noted that establishing access to international capital markets would provide additional buffers to deal with shocks.

Directors commended the authorities for achieving important international cooperation milestones such as the inclusion of San Marino in Italy's tax white list. They considered the conclusion of a memorandum of understanding with the Bank of Italy and an association agreement with the European Union to be key short- and medium-term priorities, respectively. Directors welcomed recent improvements in the business environment, and noted that continued progress along this path will help San Marino diversify its economy and develop a sustainable growth model.

[2] 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.

San Marino: Selected Economic and Social Indicators, 2012–16

GDP per capita (2013): 56,112 U.S. dollars | Life expectancy at birth (2010): 83.2 years
Population (December 2013): 31,460 persons | Literacy, adult (2008): 96 percent

				Projection	
	2012	**2013**	**2014**	**2015**	**2016**
Activity and Prices					
Real GDP (percent change)	-7.5	-4.5	-1.0	1.0	1.1
Domestic demand	-4.6	-2.9	…	…	…
Final consumption	0.0	-1.4	…	…	…
Fixed investment	-13.0	-8.4	…	…	…
Net exports (contribution to growth)	-4.1	-2.3	…	…	…
Exports	-9.8	-6.6	…	…	…
Imports	-8.9	-6.1	…	…	…
Employment (percent change)	-2.6	-1.3	-0.8	…	…
Unemployment rate (average; percent)	6.9	8.1	8.7	…	…
Inflation rate (average; percent)	2.8	1.3	1.1	0.4	0.9
Nominal GDP (millions of euros)	1401.5	1357.1	1343.5	1363.3	1392.1
Public Finances (percent of GDP) 1/					
Revenues	20.4	20.3	22.1	21.5	21.5
Expenditure	23.0	21.8	23.2	22.7	22.8
Overall balance	-2.7	-1.5	-1.1	-1.1	-1.2
Government debt	15.4	21.6	22.9	23.7	24.4
Loans	7.1	14.3	14.9	15.8	16.7
Net account payables	8.3	7.3	8.0	7.9	7.8
Government deposits (millions of euros)	72.9	55.9	40.4	45.0	45.0
Money and Credit					
Deposits (percent change)	-6.3	-6.5	…	…	…
Private sector credit (percent change)	11.4	-8.7	…	…	…
Net foreign assets (percent of GDP)	38.4	47.1	…	…	…
Commercial banks	21.9	31.8	…	…	…
Central bank	16.5	15.2	…	…	…
External Accounts (percent of GDP)					
Balance of goods and services	21.6	21.7	…	…	…
Exports	178.7	171.4	…	…	…
Imports	157.1	149.7	…	…	…
Gross international reserves (millions of U.S. dollars)	308.6	539.3	…	…	…
Exchange Rate (average)					
Euros per U.S. dollar	0.78	0.75	0.75	…	…
Real exchange rate vis-à-vis Italy	98.0	100.0	…	…	…
Financial Soundness Indicators (percent) 2/					
Regulatory capital to risk-weighted assets	8.8	13.6	13.0	…	…
Bad loans to total loans	9.6	13.9	15.3	…	…
Loan loss provision to total loans 3/	13.3	11.5	11.8	…	…
Return on equity (ROE)	-77.0	-7.5	…	…	…
Liquid assets to total assets	16.1	15.3	16.5	…	…
Liquid assets to short-term liabilities	31.7	42.8	46.6	…	…

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

1/ For the central government. Does not include possible costs of future bank recapitalization.

2/ For 2014, latest available.

3/ Based on total loan loss provision, which covers nonperforming and performing loans.

Statement by Mr. Carlo Cottarelli, Executive Director for the Republic of San Marino and Ms. Marta Spinella, Advisor to Executive Director
March 25, 2015

The Sammarinese authorities would like to thank staff for the open and productive discussions held during the Article IV consultations. They broadly agree with the comprehensive analysis reflected in the report and once again found the Fund's recommendations valuable and well-targeted.

Overview

In the aftermath of the 2008 financial crisis, San Marino was faced with a series of negative shocks both in the financial sector and in the real economy, which jointly provoked a cumulative 30 percent GDP fall and required a substantial bank consolidation. The external image of the country as an opaque tax-haven and its permanence in the Italian "black list" contributed to the decline of its banking model, while demand for tourism services and Sammarinese export goods were affected by the global crisis. Most of the large public buffers were depleted to respond effectively to the emergency; and the major credit institution (the Cassa di Risparmio di San Marino, CRSM) had to receive public sector support. Since then, the authorities of San Marino embarked on a profound and far reaching restructuring of the economy, involving significant adjustment to public expenditure, the introduction of new taxes and the development of a new economic strategy.

The country still faces downside risks, but the outlook is certainly improved and the economy is stabilizing. The recent inclusion of San Marino in the Italian "white list" is expected to enhance the business opportunities with the neighboring Italian counterparts and the international community as a whole.

The authorities are cognizant of the capacity constraints facing their country and the risks stemming from its small scale and openness, but stand fully behind their reform program and remain strongly committed to further increase San Marino's transparency, promote active participation in international fora, and maintain international best practices in the financial system.

Macroeconomic Outlook

The economy is projected to grow in 2015, albeit at a still moderate pace (1 percent), after several years of contraction, confirming the positive impact of the measures implemented by the authorities on the industrial sector and tourism. The inclusion into Italy's tax "white list" and the subsequent winding up of a bilateral economic cooperation agreement is expected to create new business opportunities not only with Italian firms (especially in the rich and active neighboring

Emilia-Romagna), but also with other foreign partners, boosting exports and attracting investments.

The authorities remain committed to diversify the economy and broaden its scope by developing new activities, turning the dramatic financial system contraction into an opportunity to attract foreign investors and rekindle the labor market.

Fiscal Policy

Before the crisis San Marino enjoyed a government surplus and high public buffers, and gross public debt was more than offset by the government deposits. During the crisis, budget surpluses turned into growing deficits, also due to the CRSM intervention. At present public debt stands at 23 percent of GDP and government deposits have been sensibly depleted.

The government, therefore, conducted a spending review, as a key component of its fiscal consolidation plan, with technical assistance from the IMF, which identified three main areas of intervention: the public sector wage bill, the public pension system and the health care benefits.

In 2014 a major income tax reform was passed, adjusting tax brackets, increasing tax rates and reducing exemptions. Administrative shortcomings in tax collection were tackled by the implementation of an electronic filing system that improved compliance.

As a result, and despite having repealed the extraordinary surtax on income and the real estate taxes, the central government deficit declined to 1.1 percent of GDP.

Savings were also achieved through the cut in public sector compensation, which only spared the lowest wages. The authorities are cognizant of the need to further consolidate, but believe that, also on account of the still uncertain output outlook, some gradualism in further fiscal consolidation is appropriate, with the 2015 budget targeted to remain broadly unchanged with respect to 2014. In accordance with the spending review recommendations, the fiscal package on public wages confirms the incentives for early retirement and maintains a low turnover ratio. This should lead to a further decline in public sector employment and wage bill. Some fringe benefits have also been cut or reduced.

The authorities agree with staff on the importance of replenishing the country's eroded fiscal buffers, and, on this account, will introduce from 2016 a fully fledged VAT regime. The VAT rates have not been defined yet.

The authorities are also planning a thorough pension reform to ensure the viability of the public pension system and guarantee generation evenhandedness. The existing generous system cannot be funded in the long term and the foreseen measures will intervene on the replacement ratio, the contribution rates and the prospective retirement age. Health expenditure will be streamlined too; also in this area the authorities are currently considering recommendations of the spending review report.

Financial Sector

After the financial crisis that led to the consolidation of several Sammarinese banks, the sector is now sound, overall, with an average of 12.7 percent capital adequacy ratio and replenished liquidity buffers, also thanks to deposits remaining stable in the last couple of years. Only CRSM still reports an inadequate capital ratio (7.5 percent) below the minimum required, despite having received sizeable public contributions (amounting to some 13 percent of GDP), and accounts for the highest level of NPLs in the system.

The authorities are aware that the banking system is still facing considerable risks due to the high level of NPLs, the still negative trend of credit demand, and reduced profitability. They agree on the need to conduct individual Asset Quality Reviews on the largest banks, most likely during the already planned on-site inspections. At the same time, they underscore the emerging recovery signs in the system, including an ongoing revenue diversification. Besides, their estimate of the NPLs' recovery ratio is higher than the one envisaged by staff, based on the analysis of the underlying assets, including with respect to the restructured Delta debits to CRSM.

That said, the authorities recognize that further early action is needed to strengthen CRSM, to achieve its complete and expedited recovery. The government currently appoints six board members out of nine, and, while as the staff report points out, the original shareholders keep a majority equity stake, the government holds the majority of voting rights, and thus, has effective control over the bank's strategy and future development. The Government is committed to recruit highly qualified experts to restructure and revamp the bank's business and the Central Bank of San Marino (CBSM) will carefully evaluate the business plan recently submitted by the CRSM management, to ensure that it fulfills all the necessary prudential requirements and will lead the bank back to profitability.

On the way forward, the authorities particularly valued the in-depth technical discussions with staff that provided insightful advice to improve the banking resolution framework and implement Basel III supervisory requirements. They recognize the need to develop a new methodological approach to supervisory practices and stand ready to enhance internal and external training (including at the Basel Committee Centre for Central Banking Studies). They are, in this respect, also considering requesting technical assistance from both the Fund (on credit risk assessment and other technical issues) and the EU (on major legal issues and needed amendments to the law).

The Central Bank will play a central role in the banking sector consolidation and enhancing supervision. In order to deal with its growing set of responsibilities, the CBSM shares the staff view on the need for additional resources and independence in their deployment.

As regards the anti-money laundering regime, MONEYVAL and the EU Commission acknowledged that San Marino's AML/CFT legal framework is compliant with the FATF requirements and with the European AML/CFT Directives and regulation. Moreover, the quality of the data collected by the Financial Intelligence Unit (FIU), as well as the exchange of information with foreign counterparts, improved significantly. The FIU, the Central Bank and other Authorities recently started to perform a national anti-money laundering risk assessment, applying the World Bank methodology, to identify existing vulnerabilities and design ad hoc countermeasures. San Marino is also preparing for the early adoption of the OECD program for the automatic exchange of tax information.

Structural Reforms

In the last couple of years, the Sammarinese authorities engaged in a comprehensive set of reforms and corrective actions to reverse the effects of the economic crisis which hit the country. The impressive progress in a limited time-span is the best proof of their concrete willingness to turn plans into action and strengthen the accountability and transparency of San Marino. Many remarkable accomplishments have already been described in previous sections of this Buff, including the tax reform, the spending review, and the progress in anti-money laundering issues.

The authorities have been very active in fostering initiatives to improve the business environment and the labor market. A newly approved law on e-commerce promoted the creation of 260 enterprises active in product scouting and basic e-commerce services; more than 20 of them constituted during the last year. A high-tech business incubator has been established to facilitate the development of a scientific and technological park connected with researchers and universities. In a few months 13 new high-tech startups were founded. After hiring Prof. Ichino, one of the major Italian experts of labor market reform, the unemployment benefits in the form of cash transfers were reduced. At the same time, vocational and requalification training programs were upgraded promoting the new recruitment of young and dismissed workers. The next steps will be a further simplification of the existing bureaucracy to facilitate foreign investments.

The continuous improvement in international cooperation also includes the recently started negotiations for an Association Agreement with the European Union, aimed at completely integrating San Marino into the EU four freedoms' framework, after having been accepted last year into the Single Euro Payment Area (SEPA).

One of the main priorities of the authorities is the prompt and successful conclusion of the Memorandum of Understanding between the Central Bank of San Marino and the Bank of Italy. To this end, they are working to realize a credit register and they amended the banking law to consent international credit information exchange. Once finalized, the MoU will allow complete exchange of credit information with Italy, provide for the resolution of some residual technical issues connected with the credit card services, and represent the leeway for the Sammarinese banks to fully access the Italian market.

The recently improved relationship with Italy are also a solid base for the new activities connected with the reopening of the Rimini-San Marino International Airport, closed after the Italian managing company went bankrupt. San Marino underwrote a public concession for the use of the airport's tarmacs and defined with the Italian authorities the logistics and the services to be provided (mainly cargo services, general and business aviation and touristic charter flights). The Sammarinese Aviation authorities along with the San Marino Aircraft Registry, thanks to a new modern law, that features very limited red tape and is aligned with high security standards, attracted to San Marino several new potential investors coming from all over the world. The project will have a tremendous impact on employment and economy for both San Marino and Italy.

A strong promotion of tourism is underway, by means of: a larger use of mass marketing instruments (social media and fair participation, among which Expo Milan 2015); a requalification of the offer, focused on a limited number of high quality cultural events; a multi-year strategic plan to attract private investment and build new structures thus increasing the availability of accommodation; the enlargement of the museum centre via the acquisition by the State of an ancient building contiguous to the existing museum; the conclusion of public-private cooperation agreements to develop specific tourist programs for impaired people.