IMF Country Report No. 16/111

REPUBLIC OF SAN MARINO

May 2016

2016 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SAN MARINO

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2016 Article IV consultation with the Republic of San Marino, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 6, 2016 consideration of the staff report that concluded the Article IV consultation with the Republic of San Marino.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 6, 2016, following discussions that ended on March 16, 2016, 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 April 21, 2016.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of San Marino.

The documents listed below have been or will be separately released.

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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INTERNATIONAL MONETARY FUND
COMMUNICATIONS DEPARTMENT

Press Release No. 16/207
FOR IMMEDIATE RELEASE
May 10, 2016

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

IMF Executive Board Concludes 2016 Article IV Consultation with the Republic of San Marino

On May 6, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino.

San Marino's economy remains in transition following the implosion of its offshore banking model in the aftermath of the global crisis. These shocks resulted in the loss of a third of output since 2008. Nonperforming loans increased to very high levels. The largest bank in the system has required 13 percent of GDP in 2012–14, and a new support operation equivalent to 3 percent of GDP is ongoing. A sound fiscal starting position allowed San Marino to use public finances to support the economy, while deficits and debt remained at sustainable levels. The country also made important progress toward improving the business environment and international cooperation.

After six years in recession, the economy is bottoming out, reflecting the improved relations with Italy and stable bank deposits. As a consequence, modest positive growth is expected this year and over the medium-term. However, risks remain, as a weak financial sector continues to cloud the outlook.

Executive Board Assessment[2]

Executive Directors welcomed the recent recovery in economic activity, and noted that while the outlook is improving, significant challenges remain. To turn the current recovery into sustainable growth, they encouraged the authorities to press ahead with efforts to strengthen the

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

[2] At the conclusion of the discussion, the 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.

banking sector, solidify fiscal buffers, and transition San Marino's economy toward a new, more diversified growth model.

Directors emphasized the importance of rehabilitating the banking system and addressing the very large stock of nonperforming loans. They endorsed a comprehensive strategy based on stronger provisioning, asset quality reviews, and recapitalization, where needed, to help banks strengthen their balance sheets and place them in a stronger position to support the economic recovery. At the same time, Directors supported further efforts to address regulatory, legal, and tax impediments to facilitate the faster resolution of nonperforming loans.

Directors noted the repeated efforts at recapitalizing Cassa di Risparmio della Repubblica di San Marino (CRSM), and stressed the need to restore its soundness and profitability, including by making its current recapitalization contingent on a deeper reorganization of the bank that quickly brings the bank back to profitability.

Directors welcomed the authorities' progress toward rebuilding fiscal buffers that have served the country well in the past. They considered a strategy aiming for a further fiscal adjustment of 1 percent of GDP over the next 4 years as appropriate to put public debt on a clear downward path while creating space to deal with adverse shocks. With a view to making room for higher capital expenditure, they supported measures to increase revenue, including through the introduction of a VAT system. In addition, efforts to contain the public sector wage bill and reform the pension system were encouraged. Directors shared the view that exploring external financing options could help break the bank-sovereign link, diversify funding sources, and provide an additional fiscal buffer.

Directors commended the authorities for their focus on improving international cooperation, the imminent completion of the AML-CFT national risk assessment, and the exchange of tax information starting in 2017. They noted that continuing and deepening recent efforts to improve the business environment and labor markets would help attract domestic and foreign investments that are needed to rebalance San Marino's economy and promote robust growth.

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.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION

April 21, 2016

KEY ISSUES

Context: A subdued recovery has started to settle in. However, downside risks persist. San Marino's economy remains in transition following the implosion of its offshore banking model in the aftermath of the global crisis, resulting in the loss of a third of output.

Challenges: Lay foundations for sustainable growth strengthening the banking system, realigning fiscal policy with new economic realities, and improving flexibility to enable the diversification of economic activity.

Key policy recommendations:

- ***Financial sector policy.*** Speed up the unfinished restructuring of the largest bank. Conduct an in-depth asset-quality assessment of the rest of the banking system followed by appropriate contingency plans. Remove legal, regulatory and tax obstacles to facilitate dealing with problem loans.

- ***Fiscal policy.*** Pursue gradual consolidation of one percent of GDP over four years to rebuild buffers. Focus adjustment on containing the public sector wage bill, pension, and health benefits. Introduce a VAT system with a revenue-increasing rate. Create fiscal space for capital investment. Establish the sovereign's access to external financing.

- ***Structural policy.*** Improve the business environment, including debt enforcement and insolvency mechanisms, to facilitate the reallocation of resources to nonbank sectors. Continue the current focus on international cooperation.

Traction of past Fund advice: The authorities undertook measures to achieve fiscal consolidation. They are designing a strategy to address nonperforming loans in the banking system, in line with staff's recommendation. They are also in the process of recapitalizing the largest bank in the country, but have yet to follow staff's advice to speed up its restructuring and improve its governance (IMF Country Report 15/94).

Approved By
Thanos Arvanitis (EUR) and Kristina Kostial (SPR)

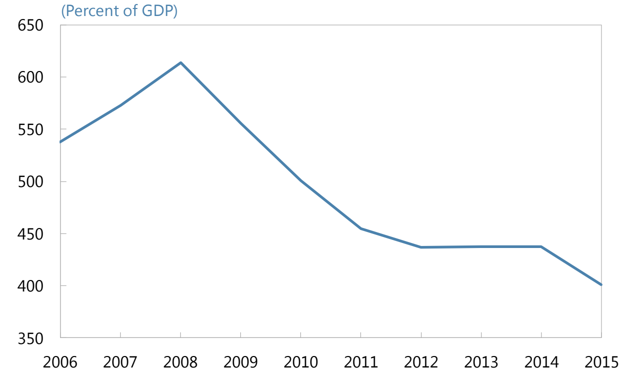
Discussions for the 2016 Article IV consultation were held in San Marino during March 8–16, 2016. The mission comprised Messrs. Tieman (head), Chai, Giustiniani, and Ms. Bersch (all EUR). Ms. Stetsenko (LEG) and Ms. Spinella (OED) joined the mission. The mission had meetings with the heads of state, the Ministry of Finance and various other Ministries, the Central Bank, trade unions, business associations, members of Parliament, and hosted a press conference.

CONTENTS

CONTEXT, OUTLOOK, AND RISKS

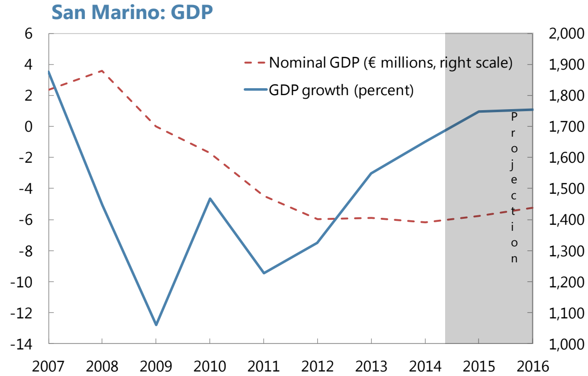
1. **The economy is bottoming out after six years of recession.** The impact of the global financial crisis, which led to a massive outflow of nonresident deposits and a sharp downsizing of its large financial sector (Box 1) caused an extraordinary loss of a third of San Marino's output—the largest in Europe. As a consequence, nonperforming loans (NPLs) increased rapidly to close to 46 percent of loans. The banking system continues to deleverage, and the economy remains in transition to a new business model. However, the authorities' efforts in recent years, as well as the inclusion in Italy's whitelist in late 2014 and the stabilization of bank deposits, set the stage for a modest recovery of about 1 percent in 2015. Industrial production and car registrations increased by 2 and 3 percent, respectively, while labor market condition stabilized. Modest growth of 1–1¼ percent is projected for 2016 and the medium-term, on the back of rebounding consumption and investment, but this is insufficient to bring the economy back to its precrisis levels.

San Marino: Banking System Assets
(Percent of GDP)



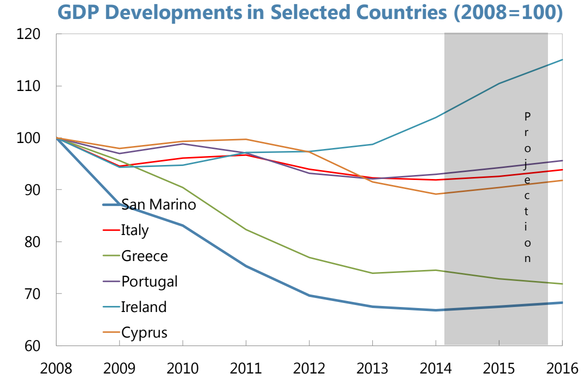
Source: Central Bank of San Marino

San Marino: GDP



Sources: San Marino Statistical Office

GDP Developments in Selected Countries (2008=100)



Sources: San Marino Statistical Office; IMF, WEO.

2. **A sound fiscal position allowed San Marino to use public finances to support the economy.** In the wake of the output contraction, the central government balance turned to a moderate deficit. In addition, public funds were used to recapitalize Cassa di Risparmio della Repubblica di San Marino (CRSM)—the largest bank in the country—totaling 13 percent of GDP (in three rounds of recapitalization). This has led to an increase in net public debt from virtually zero at the beginning of the crisis to about 20 percent of GDP in 2015. Notwithstanding the low level of public debt, options for budget financing remain limited, as the sovereign has not established access to international markets.

3. Headwinds from a weak financial sector continue to cloud San Marino's medium-term outlook (Annex I). The banking system is undergoing a sharp adjustment, with bank assets having declined from over 600 percent of GDP in 2008 to about 400 percent in 2015. Moreover, the recession in San Marino, but also in Italy where many banks have customers, led to a sharp increase in nonperforming loans and weakened the banking system. Lingering problems impede the functioning of the banking system and weigh on economic growth through effects on wealth, the provision of credit, and tax receipts, and their resolution remains a key challenge.

4. Other risks to the outlook are broadly balanced. Prolonged slow growth in Italy, and more generally in the euro area, remains a downside risk both through external demand as well as through the quality of Sammarinese banks' significant Italian assets. On the upside, the normalization of economic relations with Italy (primarily San Marino's inclusion in Italy's tax whitelist) could stimulate bilateral economic activity more than expected.

5. In addition, as a euroized microstate, San Marino faces a number of specific challenges. San Marino's very small size results in capacity constraints—including skills shortages in specific areas—, that limit the possibilities of economic diversification, and implies that even micro policy actions, such as attracting just a few small enterprises or selling a small number of homes used as collateral for nonperforming loans, often have macroeconomic implications. Macroeconomic statistics exhibit gaps: no balance of payments data is available and national accounts are published with a one-year lag. On the positive side, the country's size has led to a relatively consensus-based decision-making process and facilitates speedy implementation of agreed policies. Although euroized, San Marino is not a member of the European Union (EU) and the Eurosystem and therefore lacks a lender-of-last-resort facility. At the same time, its financial system is somewhat sheltered from turmoil on international capital markets, as the banks are fully domestically owned, not quoted on the stock exchange, and do not rely on (external) wholesale funding. Over the medium term, the country faces the significant challenge of diversifying its model of economic growth away from banking, and improving competitiveness to integrate its economy more fully into the world economy.

Authorities' views

6. The authorities shared staff's assessment that the economy is slowly returning to growth. They see positive trends in employment and new business startups. At the same time, they emphasized that the short-term costs of the ongoing efforts to comply with international best practice (e.g., the introduction of extensive anti-money laundering practices and the transposition of EU directives, see ¶20) and the implementation of deep structural reforms have thus far outweighed the long-term benefits. Going forward, the authorities emphasized their objective is to increase economic flexibility in order to improve competitiveness. They see promoting economic diversification as the main challenge and remain strongly committed to continue structural reforms. In this regard, they highlighted that capacity bottlenecks of the state administration and Central Bank of San Marino (CBSM) should be addressed.

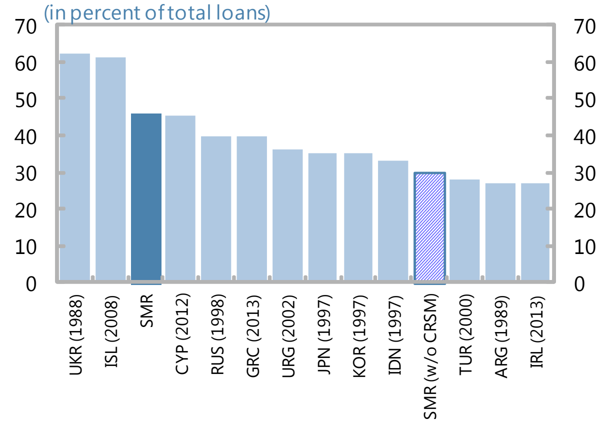
POLICY DISCUSSIONS

A. Financial Sector—Repairing Balance Sheets

The Banking System

7. **The banking system remains fragile with high and still increasing nonperforming loans, relatively low provisions, and large operating losses.** Reflecting the still weak economic environment, Sammarinese banks' NPLs have edged up to close to 46 percent of total gross loans (31 percent excluding CRSM) as of end-September 2015. Half of these NPLs are vis-à-vis nonresidents. Over the last year, loan loss provisioning has not fully kept pace, leading to a slight decline of the NPL coverage ratio to 29 percent. Declining interest margins, reflecting weak lending activity and the burden of impaired assets, together with relatively high operating costs resulted in net losses of €35 million (€18 million excluding CSRM), or 2½ percent of GDP, in 2015.

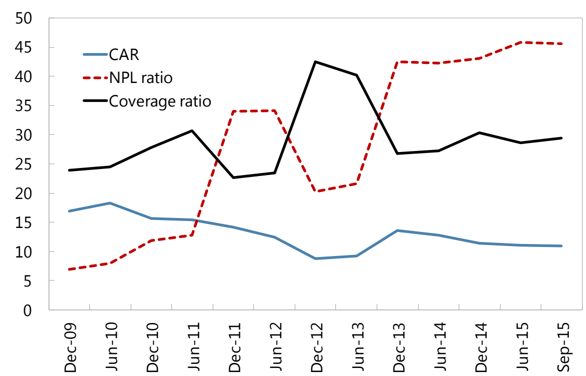
Nonperforming Loans in Systemic Banking Crisis
(in percent of total loans)



Sources: CBS; L. Laeven and F. Valencia, 2012, "Systemic Banking Crises Database: An Update," IMF WP/12/163, June; and Financial Soundness Indicators Database.

8. **The banking system falls marginally short of the 11 percent minimum capital adequacy requirement.** In particular, CRSM's capital position is weak, despite significant public capital support, and stands at 7.5 percent—€46 million (3¼ percent of GDP) short of the minimum capital requirement. Excluding CRSM, the system's capital adequacy ratio was 13.1 percent at end-September 2015. However, banks' capitalization might be overstated, as the level of loan loss provisions is relatively low.

San Marino: Banking System



Sources: Central Bank of San Marino

9. **Banks' liquidity buffers have remained broadly stable.** As of end-September 2015, liquid assets cover almost 60 percent of short-term liabilities. The Sammarinese authorities estimate that the recent Italian policy on voluntary disclosure of offshore assets has resulted in nonresident deposit outflows of about €260 million until early 2016, and could lead to some additional outflows.

10. The authorities should devise a comprehensive strategy to repair banks' balance sheets. Given the institutional setting (see ¶5), San Marino's possibilities to deal with the problem are limited and should be carefully crafted. The strategy should consist of the following steps:

- *Asset quality reviews (AQRs)*. Forward-looking AQRs for all banks are critical to reduce uncertainty on banks' asset quality. Recent on-site supervisory AQRs for three banks resulted in upward adjustment of provisions. Given existing capacity constraints, the CBSM should consider hiring external parties to speed up the process.

- *Provisioning.* On the basis of the AQR results, the CBSM should require banks to quickly meet the need for additional provisions in order to bring their NPL coverage ratios to adequate levels.

- *Capitalization*. The increase in provisions is likely to bring the capitalization of some banks below the regulatory minimum. These banks should be required to present time-bound market-based recapitalization plans to the CBSM. The plans should include a predefined set of safeguards, such as no dividend payments. Foreign investors could support recapitalization efforts, but sound fit-and-proper standards should apply.

- *Resolution*. Banks for which solvency deficiencies are unlikely to be addressed within a reasonable period of time should be resolved. For banks deemed systemically important to the domestic economy, the state could subscribe remaining capital shortfalls, while carefully considering the case for diluting existing shareholders upfront.

11. Dealing with the existing stock of NPLs remains a priority. As of end-2015, total NPLs stood at €2 billion (47 percent of total loans or 140 percent of GDP). Of this stock, €1.1 billion (57 percent of total) pertains to CRSM, mostly due to its Italian subsidiary (Delta Group) in liquidation. Excluding CRSM, about half of the remaining €837 million of NPLs are related to loans to nonresidents, mostly in Italy. This large stock of NPLs is a drag on banks' profitability and inhibits their capacity to intermediate and extend new loans.

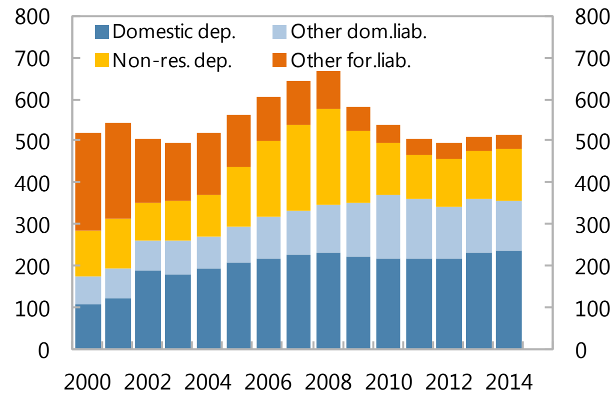
12. So far, banks have managed NPLs internally, but the three largest banks are considering creating a joint asset management company (AMC). Three special purpose vehicles have been established to deal exclusively with the impaired assets of weak banks absorbed by other Sammarinese credit institutions (see Selected Issues Paper). The three largest banks are also planning setting up a joint AMC, although, given the difficulty in agreeing on common valuation criteria for transferred assets, the AMC is expected to comprise separate funds for each of the banks. A more effective pooling of the NPL portfolios would help achieve larger economies of scale, consolidate debtor positions, and could attract potential foreign investors. However, any capital release should be avoided, since banks retain full ownership of the funds (see Selected Issues Paper).

Box 1. San Marino's Banking System: An Overview

Since the outbreak of the global crisis, San Marino's banking sector has consolidated substantially. The abrupt deleveraging and the rapid asset quality deterioration revealed pockets of vulnerability in the system. The CBSM played a key role in preserving financial stability, notably by quickly intervening some small institutions in difficulty. As a result, between 2009 and 2015, the number of operational credit institutions has declined from 12 to 7, one of which de facto operates as "bad bank" for another credit institution, while the number of operative fiduciary companies dropped from 48 to 8 over the same period. The two largest banks, CRSM and Banca di San Marino, account for 56 percent of total assets and deposits of the system. On average, about 52 percent of the loans are vis-à-vis nonresidents, while only 25 percent of deposits is from nonresidents.

Nonetheless, the banking sector remains very large and vulnerable. The size of San Marino's banking sector, measured as asset to GDP, is comparable to Cyprus and Ireland. Contrary to most other financial centers, all banks are domestically owned. Although liquidity buffers appear adequate, on average, the lack of foreign-owned subsidiaries or branches in the system prevents the Sammarinese banks from having even indirect access to sources of emergency liquidity assistance. With average capital-adequacy ratio at around 11 percent, high nonperforming loans, and relatively low loan-loss provisions, the Sammarinese banking system compares unfavorably with peer countries.

San Marino: Funding of Banks' Total Assets
(in percent of GDP)



Sources: IFS; WEO; and IMF staff calculations.

Selected Banking Sector Indicators[1/]

	Asset to GDP ratio	Number of credit institut.	o/w foreign subsidiaries and branches	Tier 1 capital adequacy ratio	NPL ratio	NPL coverage ratio	Liquidity ratio	Liquid assets to short-term liabilities	ROA
San Marino	4.8	7	0	11.9	45.6	29.4	31.0	57.2	-0.8
Cyprus	5.2	37	32	15.7	45.6	33.8	19.5	30.5	0.2
Ireland	5.1	22	19	22.1	14.9	40.2	...	...	1.0
Luxembourg	19.4	146	133	19.7	...	...	57.9	67.4	0.9
Malta	5.4	27	14	12.2	9.0	24.0	31.2	50.4	1.2

Sources: CBSM; ECB; IMF FSI Database; and IMF staff calculations.
1/ Latest available information.

13. Opening of the real estate market to nonresidents could further support the process. In the domestic market, a significant share of NPLs is related to mortgage loans. An important factor impeding timely and effective recovery of this debt is the stagnant Sammarinese property market. The market has limited capacity to absorb a large number of foreclosed properties, reflecting, among other things, existing restrictions to nonresident ownership. To improve the functioning of the property market, the authorities should explore the scope for a gradual opening of the

Sammarinese real estate market to nonresident investors, in line with San Marino's longer-term goal to integrate into the EU. This would support asset prices and hence facilitate NPL resolution.

14. Legal, regulatory and tax reforms would help deal with problem loans. While the Sammarinese framework for debt enforcement is relatively effective, the insolvency regime is almost exclusively used for asset liquidations and does not provide effective tools for debt restructuring. As a result, the system does not maximize value by preserving the continuity of financially distressed but viable businesses. To address some of these gaps in the insolvency system, the Sammarinese banks have recently adopted a code of conduct guiding multi-creditor coordination during debt restructuring. However, this process is voluntary and lacks mechanisms to make the terms of restructuring agreements binding for minority dissenting creditors (see Selected Issues Paper). In addition, the use of closed-fund AMCs by banks is complicated by a number of regulatory requirements. Dealing with these issues more comprehensively will require further legal and regulatory changes. Moreover, to encourage provisioning and write-offs, the current limit on tax deductibility of 5 percent of total loans per annum should be reconsidered.

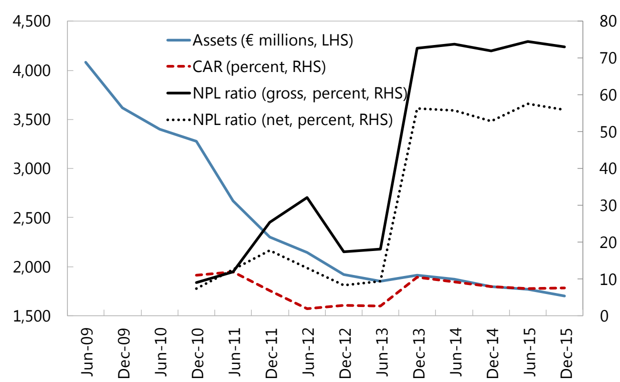
15. Additional challenges arise from the cross-border nature of a large part of NPLs. Many NPLs have a cross-border element, e.g., the borrower is nonresident and/or the collateral securing the loan is located outside San Marino, mostly in Italy. This gives rise to legal obstacles that complicate the management and resolution of problem loans, resulting in delays and high costs. Improving the framework for bilateral judicial cooperation between San Marino and Italy could help address these issues.

16. Provisioning standards and bank supervision should be strengthened to reduce the likelihood of similar problems in the future. To prevent NPL provisioning problems from re-occurring, the CBSM should gradually introduce more stringent provisioning requirements and employ stricter on-site supervision. The start of the credit registry later this year will help improve banks' credit risk assessment. Macroprudential measures, such as limits to loan-to-value and debt-to-income ratios, could also help mitigate the buildup of systemic credit risk in the banking sector.

Cassa di Risparmio

17. The fourth recapitalization of CRSM in four years is underway. CRSM underwent three separate recapitalizations over the period 2012–14 (Box 2). Its assets declined to €1.7 billion, or 121 percent of GDP by end 2015 (from 213 percent of GDP in 2009), including its Delta portfolio of Italian loans of about €700 million. Yet, CRSM remains undercapitalized, likely under-provisioned, and loss-making. In January 2016, at the request of the CBSM, CRSM submitted a revised business plan based on an estimated capital gap of €54 million, €40 million

San Marino: CRSM



Source: Central Bank of San Marino

of which would be funded by a tier-2 hybrid bond subscribed by the state. In turn, the state will issue a €40 million bond, underwritten by CRSM and the other Sammarinese banks. These bonds will be offered to the public, with placement guaranteed by the banks in case the offer goes under-subscribed. Merging a real estate company controlled by the state and the foundation (CRSM's major nonstate shareholder, see Box 2) into CRSM and the subsequent revaluation of CRSM's entire real estate portfolio is expected to close the remaining €14 million capital gap and provide an additional €10 million capital to absorb projected 2016–17 losses.

Box 2. Past CRSM Recapitalizations

CRSM is San Marino's oldest and largest bank. Even though its size has rapidly declined, it accounts for 30 percent of the system's total assets (121 percent of GDP), 38 percent of total loans, and 30 percent of customer deposits. CRSM is a domestic bank, majority owned by a foundation established by law in San Marino for charitable purposes. Since the 2014 recapitalization, the state owns 46 percent of shares, as well as the majority of voting rights. The foundation consists of some 160 individuals, who together propose and elect new foundation members. The foundation's resources are entirely financed by dividends received from CRSM in the past.

CRSM was recapitalized three times over the period 2012–2014. The liquidation Delta Group, its large Italian subsidiary, by the Bank of Italy due to alleged fraud in 2009 took a severe tall on CRSM's capitalization. As losses ate into its capital buffers, the bank needed repeated capital injections to meet its minimum regulatory capital requirement.

The first recapitalization took place in late 2012. The government extended a low interest loan to CRSM's shareholders for €60 million, which the shareholders then injected into the bank's capital together with €20 million of its own funds. With this, the foundation retained its equity stake in the bank. In exchange, the government obtained some concessions, such as the possibility to name the chairman of the bank's board and two other board members.

A second recapitalization was undertaken in early 2013. The bank issued subordinated debt for €40 million, €35 million of which was underwritten by the social security fund. For the second time, public support was granted with no dilution of the foundation's stake and limited or no conditionality.

In 2014, the bank was recapitalized for the third time. The state injected €85 million in capital in exchange for a 46 percent minority equity stake, as well as the right to appoint a majority of the bank's board members, in addition to the board's chairperson. A government bond fully subscribed by CRSM financed the capital injection. Despite repeated public support (totaling 13 percent of GDP), the foundation was able to preserve a majority stake as well as veto power over any sale of the state's shares in the bank.

18. The modalities of this operation fall short of international best practice. The recapitalization does not include upfront dilution of existing nonstate shareholders, who, according to best practice, should be the first in line to finance losses. While offering the state bond to the public is a step in the right direction, the authorities could have considered external financing to fully break the bank-sovereign feedback loop.

19. To limit the risk of further public support, the current recapitalization of CRSM should be contingent on a solid reorganization plan that brings the bank back to profitability. The bank's revised business plan continues to rely on overly optimistic assumptions even in the envisaged adverse scenario. The plan should illustrate how the bank would be able to regain profitability under a relatively conservative downside scenario, likely requiring a more aggressive downsizing. Contingency plans need to be formulated in case the restructuring process is unsuccessful. In addition, the state as the main shareholder should appoint experienced turnaround experts to CRSM's board and executive management positions. Without such measures, the bank is likely to remain loss-making and hence the risk of future recapitalization needs remains high.

20. Addressing the financial sector challenges requires close coordination among the stakeholders and additional resources. Developing a strategy aimed at cleaning-up banks' balance sheets and streamlining laws, regulation, and taxation calls for close coordination between the CBSM, the government, the banks, and the judiciary. To this end, the establishment of a time-bound working group could be considered. Furthermore, the CBSM requires additional resources, and full independence in their deployment. Going forward, it needs sufficient capacity to bolster bank supervision (including the AQRs), transpose EU directives (including the Capital Requirements Regulations and Directive and the Bank Recovery and Resolution Directive, as required by the monetary agreement with the EU), and finalize the credit register.

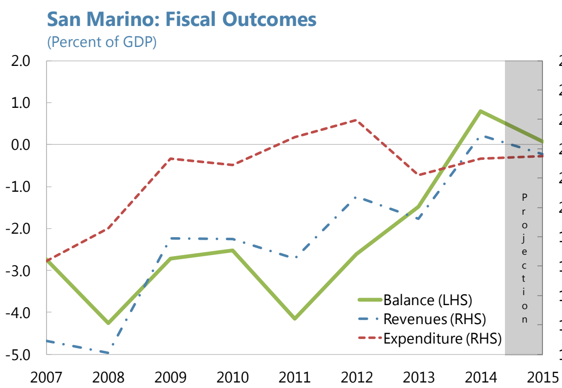
Authorities' Views

21. The authorities concur that banks' balance sheets need to be repaired. They note that capacity constraints have prevented speeding up banks' AQRs. The central bank is working on a comprehensive strategy to address the NPL problem. The authorities acknowledged the need for close coordination in developing and implementing this strategy. Since insolvency procedures are seldom used in San Marino, the authorities were of the view that improvements in the legal and regulatory framework might deliver only marginal benefits. Nevertheless, they considered staff's recommendations useful and welcome. They stressed that scrapping the limit on tax deductibility of provisions and write-offs might have substantial fiscal consequences, as the limit also applies to nonfinancial companies. Thus they saw a temporary exemption from this limit narrowly targeted at banks' existing NPL portfolios as a more viable solution.

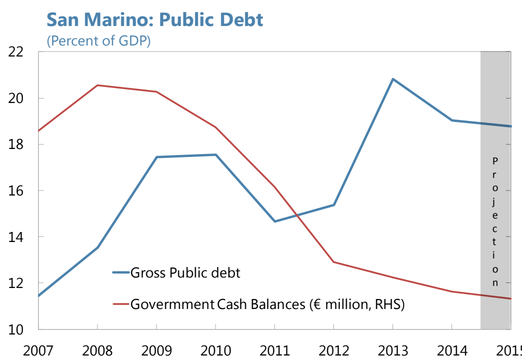
22. The authorities see bringing CRSM back to profitability as a crucial challenge. They pointed out that CRSM's Delta portfolio consists of restructured loans, for which credit risk should now be low, and note that excluding Delta assets, CRSM's financial position would be broadly in line with the rest of the Sammarinese banking system. To inform a strategy to deal with CRSM's restructuring, the authorities have requested IMF technical assistance. The authorities have also started renegotiating CRSM's ownership structure with the foundation, to better reflect past and current state support.

B. Public Finances—Rebuilding Buffers

23. With the fading of the one-off factors that supported the 2014 outturn, the central government's budget is expected to have been broadly balanced in 2015. The central government registered a 0.8 percent of GDP surplus in 2014, mainly due to expenditure restrain (1½ percent of GDP) and strong revenue collection due to concerted collection efforts of tax arrears resulting in unusually high one-off collections. While 2015 data are not yet available, revenue and expenditure trends thus far are in line with budget numbers. Revenue is expected to have decreased modestly from 2014 as one-off collections fade and nontax revenue decreased reflecting less income from transactions with third parties. Expenditure is expected to have remained flat, with higher transfers to the social security fund largely offset by lower capital outlays. Gross public debt declined slightly to 19 percent of GDP.



Sources: San Marino MoF



Sources: Ministry of Finance

24. The budget deficit is expected to turn to a ½ percent of GDP deficit in 2016. This deterioration is driven by an increase in capital investment by €10 million (0.8 percent of GDP) annually in 2016–18. Over the medium term, the fiscal deficit is expected to remain close to ½ percent of GDP, as revenue is expected to decrease to 21¼ percent of GDP largely due to dwindling profits of public corporations, compensated by lower current expenditure due to continued containment of the public sector wage bill and an improved outlook for social security expenditure. On current policies, gross debt is projected to reach 21 percent of GDP by 2020, taking into account the €40 million CRSM recapitalization bond issued this year and the increased capital spending, but no further recapitalization needs.

25. The mission advised that San Marino should gradually rebuild the fiscal buffers that served it well in the past. The planned additional capital investment in 2016–18 is appropriate, as capital expenditure, which generally improves productivity and hence growth potential, has fallen to unsustainably low levels during the recession. The resulting small projected 2016 fiscal deficit can be accommodated, given that growth is expected to be in line with medium-term forecasts and debt remains stable over the medium-term. Starting next year, once growth is entrenched, a modest adjustment of 1 percent of GDP (compared to the baseline without the additional capital expenditure, or 1¾ percent of GDP when compared to the baseline including the additional capital expenditure) over four years to reach a primary surplus of 1¾ percent of GDP by 2020 would put debt on a clear downward trajectory and create fiscal space to deal with shocks from the potentially large contingent liabilities looming in the banking system. Under such a fiscal stance, gross debt would decline to 15½ percent of GDP by 2020, and a contingent shock of 20 percent of GDP would be manageable with gross debt peaking slightly above 40 percent of GDP (text table and Annex II). If the economy were to fall back into recession, the authorities should let automatic stabilizers (e.g., unemployment insurance and wage supplements for underemployed workers) work fully.

San Marino: Gross Public Debt and Primary Deficit under Different Scenarios

(percent of GDP)

	2015	2016	2017	2018	2019	2020
			Public Debt			
Baseline (incl. capex) 1/	18.8	21.8	21.6	21.5	21.5	21.4
Baseline+adj 2/	18.8	21.5	20.2	18.9	17.3	15.5
Contingent shock 3/	18.8	41.6	41.5	41.7	41.7	42.0
Contingent shock +adj 2/ 3/	18.8	41.5	40.5	39.4	37.9	36.3
			Primary Balance			
Baseline (excl. capex)	0.3	0.6	0.9	0.8	0.8	0.8
Baseline (incl. capex) 1/	0.3	-0.2	0.1	0.0	0.0	0.0
Baseline+adj 2/	0.3	-0.2	1.1	1.2	1.5	1.7
Contingent shock 3/	0.3	-20.2	0.1	0.0	0.0	0.0
Contingent shock +adj 2/ 3/	0.3	-20.2	1.1	1.2	1.5	1.7

source: IMF staff calculations

Notes: 1/ Additional capital expenditure of 0.8 percent of GDP startingin 2016 is included in the baseline.

2/ Adjustment involves fiscal consolidation of 1% of GDP over four years, with 0.75% of GDP additional revenue from the introduction of VAT in 2017.

3/ Shock senario assumes a contingent financial liability shock of 20% of GDP.

26. Fiscal adjustment should focus mainly on expenditure rationalization combined with modest revenue increases. Over the last few years, the government has successfully controlled the public sector wage bill, which has shrunk by ½ percent of GDP. Nevertheless, it is still high and expenditure measures should continue to target the public sector wage bill—both through wage restraint and employment. In addition, the government has set up a working group to explore options for pension reform to ensure the system's long-term sustainability. These expenditure measures combined could yield ¼ percent of GDP annually in each of the years 2017–2020, for an overall expenditure reduction of 1 percent of GDP. The introduction of the VAT system next year—for which the authorities have prepared draft legislation and consultations are ongoing—should go ahead as planned, and should be used to increase revenue by some ½–1 percent of GDP, by setting the average VAT rate somewhat higher than the revenue-neutral rate.[1] Together with the revenue increase, this will create fiscal space of around ½–1 percent of GDP to finance planned capital expenditure of 0.8 percent of GDP in 2017 and beyond.

27. Establishing access to external financing for the sovereign would help diversify funding sources and break the bank-sovereign link. Given the expected small size of potential financing needs, an external private placement or syndicated loan could be considered instead of borrowing on international capital markets. Establishing access to external financing would provide an important buffer to respond to shocks that could simultaneously raise borrowing needs and leave domestic banks unable to lend to the government. The current low international interest rates present a window of opportunity, as they limit the additional cost. In addition, an agreement on a contingent credit line from the Italian authorities would provide a welcome insurance against liquidity shocks.

Authorities' Views

28. The government agreed on the importance of rebuilding fiscal buffers. Public finances have stabilized after many years of recession and adjustment. Looking forward, the authorities see the need for further capital investment, and at the same time are committed to further fiscal consolidation to put debt on a downward path and be prepared for possible future shocks. They highlighted that their policies and the ongoing modest resumption of growth have already reduced the deficit and stabilized debt. To support the public pension system, the government obtained a parliamentary mandate to study reform options to ensure the system's long-term sustainability. The authorities consider the introduction of the VAT in 2017 a priority, emphasizing this in public. However, they note opposition to the VAT system from service and domestic trade companies, whereas the export sector supports the change. Given this opposition, the authorities plan to set a revenue-neutral average VAT rate, and phase the VAT in gradually. The government views the public placement of the state bond to recapitalize CRSM as a step toward breaking the bank-sovereign feedback loop. Going forward they will consider external financing options.

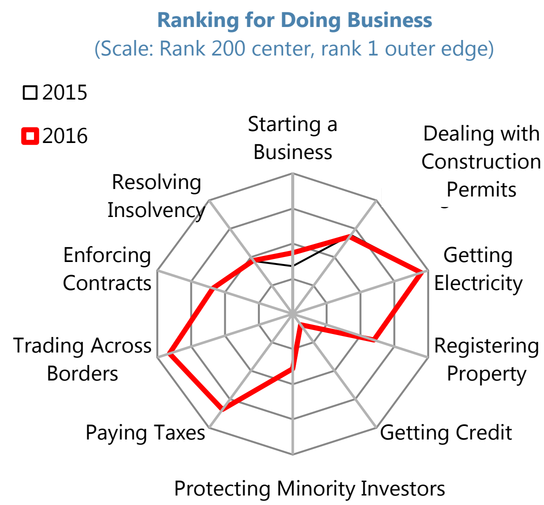
C. Structural—Seeking a New Growth Model

29. San Marino made important progress toward improving the business environment and liberalizing the labor market. Improvements in the business environment support a gradual rebalancing of the economy towards industry and nonfinancial services. The government has, for example, set up a high-tech business incubator, put in place a simple and fast online process to establish a business (improving the country's ranking by 17 positions to 76th in the World Bank's Doing Business ranking), and has simplified the registration of property. Recent changes to labor market policies, such as establishing an entry-level wage below the lowest level in collective wage agreements, and temporary lower social security contributions when hiring unemployed workers,

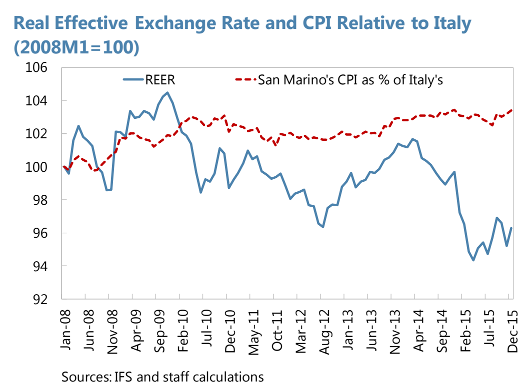
[1] Currently service businesses pay a 3 percent service tax, while most imports face a standard import tax of 17 percent. The VAT will replace these taxes and is expected to improve efficiency.

support employment. The government has also exempted small high-tech businesses in the incubator from the slow and complicated procedures to hire skilled nonresident workers.

30. A more favorable business environment and flexible labor market are essential to successfully transition to a more diversified economy. Further improvements to the business environment as well as reforming the insolvency and debt restructuring regimes (see ¶14 and the Selected Issue Paper) would support economic diversification towards a nonbank growth model. Incentives and tax breaks for new investments and projects can also be included in the policy mix, but should be subject to a careful cost-benefit analysis. Further streamlining of the procedures to hire skilled nonresident workers should be considered, as this would enable San Marino to take greater advantage of the labor market in the dynamic neighboring Italian regions.



31. Price competitiveness improved modestly, while net foreign assets remained stable. On the back of the steep euro depreciation since mid-2014, a proxy[2] for San Marino's real effective exchange rate (REER) has now fallen close to its lowest level since the start of the crisis, largely on the back of movement in Italy's real effective exchange. These available price-based indicators and the stability of net foreign assets at around two months of imports (Figure 2) suggest no significant balance of payments imbalances.



32. San Marino's continued emphasis on international cooperation has paid off and remains crucial going forward. Last year, San Marino (together with Andorra and Monaco) has started negotiations on an association agreement with the EU. In addition, San Marino's improved openness and transparency enabled the conclusion of the bilateral economic cooperation agreement with Italy and Italy's inclusion of San Marino in its tax whitelist. Going forward, the Sammarinese authorities should continue improving this cooperation with Italy. In particular, the CBSM's new senior management will need to rebuild and broaden the relations with the Bank of Italy, which previously relied on a few individuals that were replaced. In this context, the recent legislative change to allow the exchange of credit information with the Bank of Italy even in the absence of a signed Memorandum of Understanding is a positive development. It enables the

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

imminent start of the credit register to be followed by the exchange of credit information with Italy later this year. The expected completion of the national risk assessment this summer and the start of the exchange of tax information in 2017 are further welcome steps.

Authorities' Views

33. The authorities agreed on the need to diversify San Marino's economy, and the crucial role that international cooperation plays in this regard. They consider continued structural reform important to facilitate economic diversification. In this regard, the authorities emphasized the success of the high-tech business incubator as well as the start of Sammarinese business aviation and cargo services at Rimini airport under a special agreement with Italy. Future plans include upgrading the basic tourism infrastructure, to facilitate further private investment in this sector with the aim of attracting multi-day tourists and increasing per-visitor spending. The authorities expect to soon start seeing the economic benefits from inclusion in Italy's tax whitelist. The broader long-term goal remains concluding the association agreement with the EU, fully integrating San Marino with the EU's four freedoms and thus leveling the playing field for Sammarinese business in Europe.

D. Data Provision

34. Data provision is broadly adequate for surveillance purposes, but gaps exist. While these data gaps are not uncommon for very small countries, San Marino needs 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. Importantly, banking sector data are comprehensive and timely.

STAFF APPRAISAL

35. San Marino is emerging from a prolonged recession, but important challenges remain. There are signs of a modest economic recovery, yet headwinds from high nonperforming loans in the banking sector and the still incomplete restructuring of CRSM continue to cloud the outlook. On the upside, stronger growth in Europe and Italy and the normalization of economic relations with the latter could stimulate bilateral economic activity more than expected.

36. A comprehensive strategy is needed to clean up banks' balance sheets. The current large stock of nonperforming assets is a drag on banks' profitability and inhibits their capacity to intermediate and extend new credit. Therefore, addressing the sheer size of the NPL stock is crucial to safeguard financial stability and support San Marino's nascent economic recovery. A policy based on stocktaking, provisioning, and, where needed, recapitalization, would serve to repair banks' balance sheets. The central bank's focus on designing such a plan is welcome. At the same time, regulatory, legal and tax impediments to NPL management and resolution should be addressed, including by removing tax disincentives to NPL write-offs, enhancing the insolvency regime to facilitate reorganization of viable companies, and relaxing the regulation governing asset management companies. Lastly, to improve the functioning of the real estate market and hence support asset value and sales, the scope for a gradual opening of the Sammarinese property market to nonresident investors should be explored.

37. The steadfast implementation of this strategy requires close coordination among stakeholders and likely additional resources. Intensive coordination among the government, the CBSM, the banks, and the judiciary is crucial for the success of the strategy. In this regard, the CBSM's attention to the NPL problem and to policies addressing it is welcome. It remains important to ensure the CBSM is adequately resourced its tasks and can exercise its duties independently.

38. The recapitalization of CRSM should be contingent on a deeper reorganization that quickly brings the bank back to profitability. This will likely require more aggressive downsizing of the bank. In addition, the state as main shareholder should appoint experienced turnaround experts to CRSM's board and executive management positions. Any injection of public resources should carefully consider the dilution of nonstate shareholders.

39. San Marino should gradually rebuild the fiscal buffers that served it well in the past. These buffers have allowed the state to cushion social expenditure during the crisis and its aftermath, and would be needed again to respond similarly to future shocks. An overall fiscal adjustment of 1 percent of GDP over four years would put debt on a clear downward path and create room to deal with potentially large contingent liabilities looming in the banking system.

40. This modest fiscal adjustment should start next year. The additional public capital expenditure from the budget of €10 million annually starting this year will help support the recovery. The resulting modest deficit should be accommodated this year. Starting in 2017, the aim should be to modestly increase revenue, while reducing current expenditure by ¼ percent of GDP per year in 2017–2020. This would create room to permanently accommodate the higher capital expenditures.

41. The scheduled introduction of the VAT in 2017 remains a priority, while containing the public sector wage bill and reforming the pension system are also important. The introduction of the VAT should aim to increase revenues by ½–1 percent of GDP. Expenditure policies should focus on further reducing the public sector wage bill, as well as rationalizing and modestly reducing spending on public pensions and publicly financed health care benefits. In this context, staff welcomes the authorities' commitment to reform the public pension system and the recent setup of a working group to explore options to ensure the system's long-term sustainability.

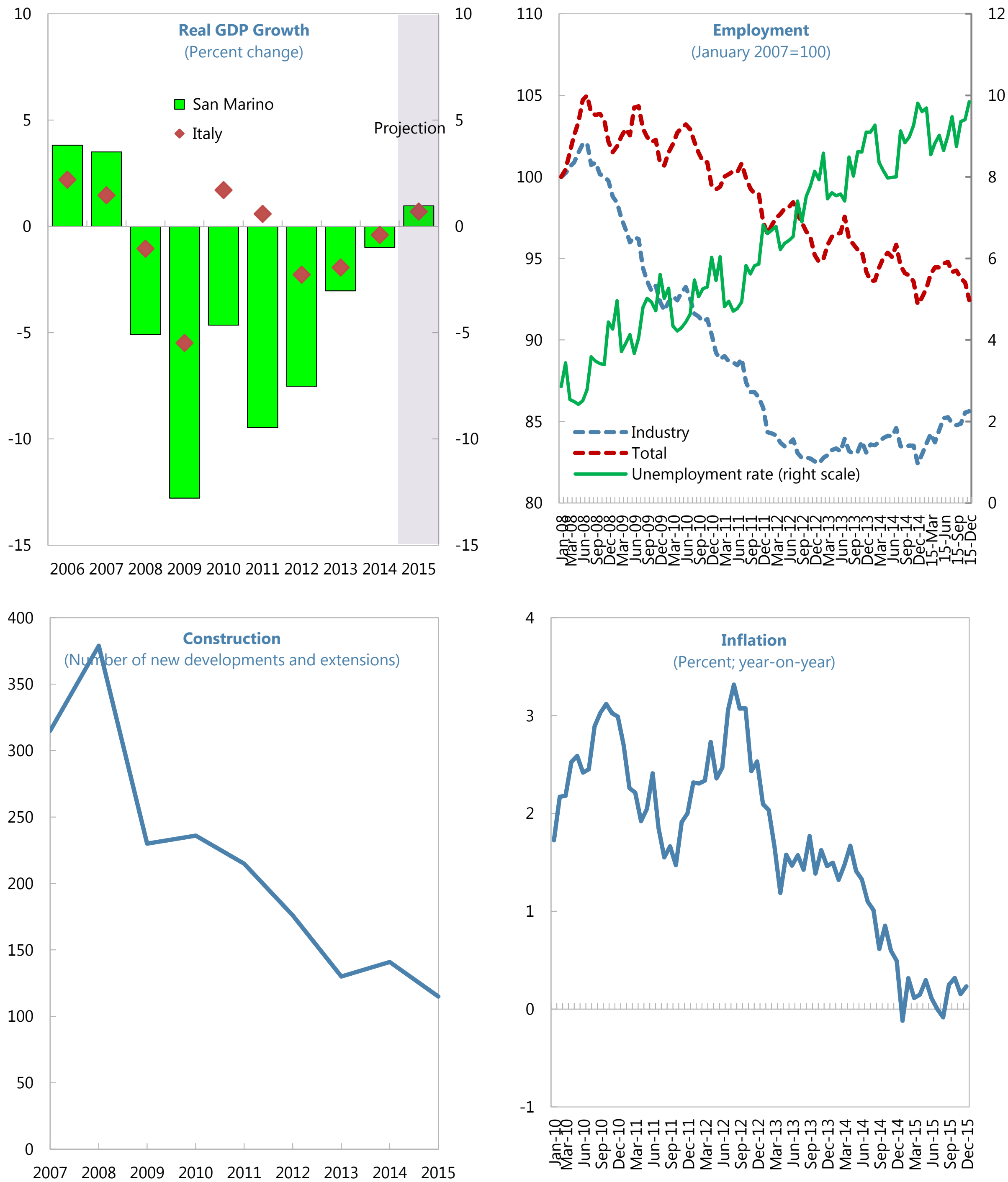
42. External financing options should be considered. This would help diversify funding sources and break the bank-sovereign link. Since potential financing needs may be too small to tap international capital markets in a cost effective way, an external private placement or syndicated loan could be considered.

43. The government took important steps to improve the business environment and labor markets. Examples include simplification of the process to establish a business and register property. The government has piloted streamlined procedures to hire skilled nonresident workers for startups, and should consider scaling up such efforts to the economy more generally. It has also set up a high-tech business incubator, where the first start ups are now operational and expanding. Such changes are important to support rebalancing of the Sammarinese economy.

44. San Marino's focus on improving international cooperation has paid off, and should be maintained. The opening of negotiations with the EU on an association agreement and the conclusion of the bilateral economic cooperation agreement with Italy are important achievements. The activation of the credit register should start as scheduled, thereby enhancing the cooperation with the Bank of Italy and helping banks upgrade their credit risk assessment. Lastly, staff welcomes the imminent completion of the AML-CFT national risk assessment, and the exchange of tax information starting in 2017.

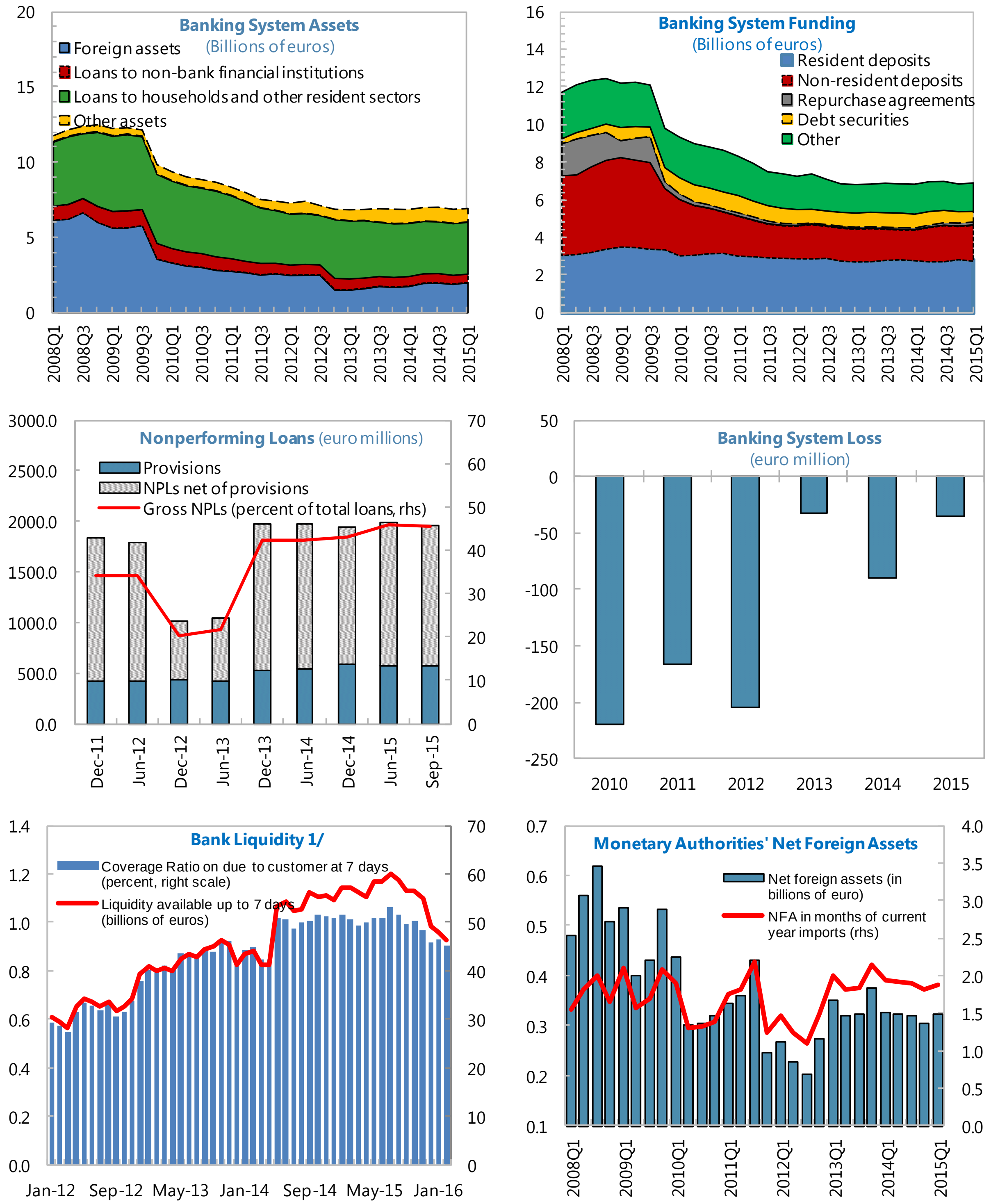
45. It is recommended that the next Article IV consultations with the Republic of San Marino be held on the standard 12-month cycle.

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



Source: 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 (2014): 44,216 U.S. dollars — Life expectancy at birth (2010): 83.2 years
Population (December 2013): 31,448 persons — Literacy, adult (2008): 96 percent

	2012	2013	2014	Projection 2015	Projection 2016
Activity and Prices					
Real GDP (percent change)	-7.5	-3.0	-1.0	1.0	1.1
Domestic demand	-4.6	-1.4	-3.6	...	...
Final consumption	0.0	0.1	-2.0	...	...
Fixed investment	-13.0	-7.0	-17.2	...	...
Net exports	-4.1	-2.3	2.1	...	...
Exports	-9.8	-6.6	-1.0	...	...
Imports	-8.9	-6.1	-2.5	...	...
Contribution to GDP					
Domestic demand	-3.4	-1.0	-2.7		
Final consumption	0.0	0.0	-1.2		
Fixed investment	-2.9	-1.5	-3.4		
Net exports	-4.1	-2.3	2.1		
Exports	-18.1	-11.8	-1.6		
Imports	14.0	9.5	3.8		
Employment (percent change)	-2.4	-1.4	-1.6	...	...
Unemployment rate (average; percent)	6.9	8.1	...	...	...
Inflation rate (average; percent)	2.8	1.3	1.1	0.4	0.9
Nominal GDP (millions of euros)	1401.5	1404.7	1390.5	1410.9	1438.8
Public Finances (percent of GDP) 1/					
Revenues	20.4	19.6	22.5	21.8	22.0
Expenditure	23.0	21.1	21.7	21.8	22.6
Overall balance	-2.6	-1.5	0.8	0.1	-0.6
Government debt	15.4	20.8	19.0	18.8	21.8
Government deposits (millions of euros)	72.9	55.9	40.4	32.9	32.9
Money and Credit					
Deposits (percent change)	-1.6	-2.0	1.9	...	...
Private sector credit (percent change)	11.2	-9.6	1.0	...	...
Net foreign assets (percent of GDP)	-26.7	4.4	-4.0	...	...
Commercial banks	-46.3	-22.2	-25.9	...	...
Central bank	19.5	26.6	21.9	...	...
External Accounts (percent of GDP)					
Balance of goods and services	21.6	21.7	25.9	...	...
Exports	178.7	171.4	171.4	...	...
Imports	157.1	149.7	145.4	...	...
Gross international reserves (millions of U.S. dollars)	385.0	539.3	392.0	...	...
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	11.4	11.0	...
Bad loans to total loans	9.6	13.9	16.1	18.4	...
Loan loss provision to total loans	42.5	26.7	30.3	29.4	...
Return on equity (ROE)	-22.5	-7.8	-21.4	-11.5	...
Liquid assets to total assets	28.0	29.6	32.4	31.0	...
Liquid assets to short-term liabilities	58.7	60.6	65.4	57.2	...

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

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

2/ For 2015, latest available.

Table 2. San Marino: Selected Economic and Social Indicators for the Medium Term

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
				Projection						
Real and External										
Real GDP (percent change)	-7.5	-3.0	-1.0	1.0	1.1	1.2	1.3	1.3	1.3	1.3
Net exports	-4.1	-2.3	2.1	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Exports	-18.1	-11.8	-1.6	1.7	1.9	2.1	2.3	2.2	2.3	2.3
Imports	14.0	9.5	3.8	-1.4	-1.6	-1.8	-1.9	-1.9	-1.9	-1.9
Public Finances (percent of GDP) 1/										
Revenues	20.4	19.6	22.5	21.8	22.0	21.8	21.3	21.3	21.3	21.3
Expenditure	23.0	21.1	21.7	21.8	22.6	22.1	21.8	21.8	21.8	21.8
Overall balance	-2.6	-1.5	0.8	0.1	-0.6	-0.3	-0.4	-0.4	-0.4	-0.4
Primary balance	-2.5	-1.4	1.0	0.3	-0.2	0.1	0.0	0.0	0.0	0.0
Government debt	15.4	20.8	19.0	18.8	21.8	21.6	21.5	21.5	21.4	21.4

Sources: IMF; 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.

Table 3. San Marino: Financial Soundness Indicators, 2009–15

	2009	2010	2011	2012	2013	2014	Jun-15	Sep-15
Capital adequacy ratios (percent)								
Regulatory capital to risk-weighted assets	16.9	15.6	14.1	8.8	13.6	11.4	11.1	11.0
Capital to assets	10.6	9.6	8.6	6.3	7.3	6.2	7.0	7.0
Asset quality ratios (percent)								
Bad loans to total loans 1/ 2/	2.9	5.9	7.2	9.6	13.9	16.1	16.9	18.4
Nonperforming loans to total loans	6.9	11.9	34.1	20.3	42.4	43.1	45.8	45.6
Bad loans net of provision to capital 1/ 3/	7.2	17.6	28.7	41.3	47.3	57.3	67.3	73.7
Nonperforming loans net of provision to capital	36.5	72.5	273.1	166.1	289.2	335.8	368.0	370.5
NPL coverage ratio	23.9	27.8	22.6	42.5	26.7	30.3	28.6	29.4
Earning and profitability (percent)								
Return on assets (ROA) 4/	0.1	-0.1	-3.3	-2.2	-0.6	-1.8	-0.4	-0.8
Return on equity (ROE) 4/	0.5	-0.7	-28.8	-22.5	-7.8	-21.4	-5.5	-11.5
Interest margin to gross income	67.5	56.1	77.1	58.5	46.1	32.1	37.4	38.7
Non-interest expenses to gross income	34.1	48.3	66.7	69.7	81.2	50.7	62.6	63.8
Trading income to gross income	12.8	1.5	-6.3	11.7	13.3	13.9	4.0	-1.3
Administrative expenses to non-interest expenditures 1/ 2/	51.3	61.9	69.2	69.7	66.1	55.6	59.5	57.1
Liquidity (percent)								
Liquid assets to total assets	29.9	27.9	25.8	28.0	29.6	32.4	32.0	31.0
Liquid assets to short-term liabilities	57.1	67.4	57.6	58.7	60.6	65.4	62.3	57.2
Loans to deposits	76.5	85.0	76.8	91.8	86.7	80.0	78.9	79.3

Sources: CBSM; IMF, Financial Soundness Indicators (FSI); and IMF staff calculations.

1/ Based on bank balance sheet data.
2/ Last observation refers to December 2015.
3/ Last observation refers to bad loans net of provisions as of December 2015 and capital as of September 2015.
4/ Before extraordinary items and taxes.

Table 4. San Marino: Statement of Operations for Budgetary Central Government, 2010–17
(Percent of GDP)

						Projection		
	2010	2011	2012	2013	2014	2015	2016	2017
Revenue	18.9	18.3	20.4	19.6	22.5	21.8	22.0	21.8
Taxes*	14.2	13.0	14.6	14.6	17.2	17.0	17.0	17.4
Income Taxes	7.5	7.1	7.0	7.4	8.1	8.1	8.0	8.2
Non-income taxes	6.7	5.9	7.6	7.2	9.1	8.9	9.0	9.2
Taxes on international trade and transactions	4.0	3.5	4.5	5.1	6.4	6.4	6.5	6.8
Other taxes	2.7	2.5	3.0	2.1	2.7	2.5	2.5	2.5
Non-tax revenue	4.7	5.2	5.8	5.0	5.3	4.9	5.1	4.3
Expenditure	21.4	22.4	23.0	21.1	21.7	21.8	22.6	22.1
Current Expenditure	18.9	19.8	20.7	19.7	19.6	20.4	20.3	19.9
Compensation of employees	6.4	6.8	7.1	7.1	6.6	6.7	6.6	6.5
Use of goods and services	1.8	2.0	2.1	1.9	2.2	2.1	2.1	2.0
Interest	0.1	0.1	0.1	0.1	0.2	0.3	0.4	0.4
Transfers	10.3	10.7	11.1	10.4	10.3	11.0	10.8	10.7
To other general government units	9.6	9.6	10.3	9.7	9.6	10.2	10.1	10.0
Other expenses (including subsidies)	0.3	0.3	0.3	0.3	0.2	0.4	0.3	0.3
Capital Expense	2.6	2.6	2.2	1.4	2.1	1.3	2.3	2.1
Net lending (+)/borrowing (-) (fiscal balance)	-2.5	-4.1	-2.6	-1.5	0.8	0.1	-0.6	-0.3
primary balance	-2.4	-4.1	-2.5	-1.4	1.0	0.3	-0.2	0.1
Memorandum items								
Social Seurity balance	...	-0.2	-0.8	-0.7	-0.4	...	...	...
Public debt	17.5	14.7	15.4	20.8	19.0	18.8	21.8	21.6
Government deposits	13.5	10.4	5.2	4.0	2.9	2.3	2.3	2.2
Nominal GDP (in millions of euros)	1615.3	1477.5	1401.5	1404.7	1390.5	1410.9	1438.8	1472.4

* Does not reflect the introduction of the VAT, planned for 2017.

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

Appendix I. Risk Assessment Matrix[1]

Risk	Relative likelihood	Impact if realized	Policy Response
Structurally weak growth in Italy and the euro area. Weak demand and persistently low inflation from a failure to fully address crisis legacies and undertake structural reforms, leading to low medium-term growth and persisting financial imbalances in the euro area and Italy in particular.	**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.
Further modest public bank recapitalizations.	**High**	**Medium** Public finances could cope with modest further bank recapitalization needs.	• Accelerate establishing access to external financing 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.	
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.
Loss of cross-border or domestic electronic payment services: significantly curtails	**Low**	**Medium** Disruption of retail and wholesale electronic payment services leads to an abrupt	• The authorities are working on mitigating the risk by setting up a

[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.

domestic and cross-border payments.		adjustment in consumption and trade. A sudden shift to cash may cause short-term currency shortages.	domestic electronic payment services provider.
Tensions with neighboring Italy resurface.	**Low**	**High** Persistent tensions would dissuade Italian corporates and banks from doing business with San Marino, thus affecting growth.	• Enhance focus on international relations. • Start the credit register on schedule. • Continue to work towards early adoption of OECD initiative for exchange of tax information.

Appendix II. Public Debt Sustainability

1. San Marino's gross central government debt is projected to stabilize below 22 percent of GDP. Before the crisis, gross debt stood below 15 percent of GDP. Net debt was negative, as the government held cash buffers in excess of 15 percent of GDP. However, the crisis swung budget surpluses into deficits, which, together with financial support to CRSM amounting to 13 percent of GDP,[1] increased gross debt to more than 20 percent of GDP by 2013, while cash buffers decreased to below 4 percent of GDP. In 2014, gross public debt temporarily dropped to 19 percent of GDP, due to fiscal over-performance. However, the fiscal balance is expected to deteriorate modestly in 2015 –2016 and over the medium term, including due to higher capital expenditure. In addition, the government is in the process of issuing a €40 million bond to recapitalize CRSM. In light of these developments, public debt is projected to stabilize at 21–22 percent of GDP.

2. The possible need for further bank capital support represents the main risk to public finances and debt sustainability. A contingent liability shock scenario where further recapitalization needs amount to 20 percent of GDP—reflecting a combination of further capital needs from CRSM and other banks—would, without a change in the fiscal stance, dramatically increase public debt, reaching 42 percent of GDP by 2020. Such dynamics may not prove sustainable in a country without a track record of sovereign bond issuance and untested ability to access external financing.

3. Fiscal adjustment is needed given these observations. Staff's suggested adjustment of 1 percent of GDP (compared to 2016 projections excluding additional capital expenditure) over four years would put public debt on a clear downward trend and provide fiscal space for contingent liabilities. Under these adjustments, debt would peak below 42 percent of GDP and decrease to 36 percent of GDP by 2020, even in the presence of the above-mentioned 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

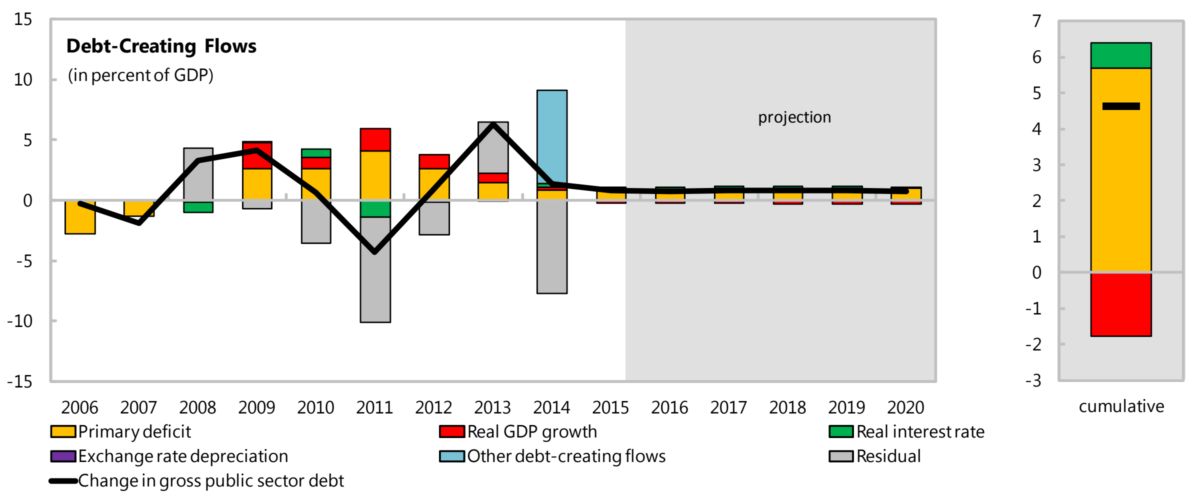
(In Percent of GDP Unless Otherwise Indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of January 31, 2015		
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	13.3	22.0	23.4	24.2	24.9	25.8	26.5	27.3	28.0	EMBIG (bp) 3/		n.a.
Public gross financing needs	0.6	0.8	0.3	4.1	7.9	8.0	12.6	12.8	13.0	5Y CDS (bp)		n.a.
Real GDP growth (in percent)	-6.6	-4.5	-1.0	1.0	1.1	1.2	1.3	1.3	1.3	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	4.4	1.4	0.0	0.5	1.0	1.3	1.5	1.6	1.7	Moody's	n.a.	n.a.
Nominal GDP growth (in percent)	-1.0	-3.2	-1.0	1.5	2.1	2.5	2.8	2.9	3.0	S&Ps	n.a.	n.a.
Effective interest rate (in percent) [4/]	1.0	0.6	1.3	1.6	1.6	1.7	1.8	2.0	1.9	Fitch	BBB+	BBB+

Contribution to Changes in Public Debt

	Actual							Projections			
	2006-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing
Change in gross public sector debt	0.4	6.3	1.4	0.8	0.8	0.8	0.8	0.8	0.7	4.6	primary
Identified debt-creating flows	3.2	2.1	9.1	0.8	0.8	0.8	0.8	0.8	0.7	4.6	balance [9/]
Primary deficit	1.1	1.4	0.9	0.8	0.9	1.0	1.0	1.0	1.0	5.7	-0.3
Primary (noninterest) revenue and grants	20.1	20.8	22.6	22.0	22.0	22.0	22.0	22.0	22.0	131.9	
Primary (noninterest) expenditure	21.1	22.2	23.5	22.8	22.9	23.0	23.0	23.0	23.0	137.6	
Automatic debt dynamics [5/]	0.9	0.6	0.5	0.0	-0.1	-0.2	-0.2	-0.2	-0.3	-1.1	
Interest rate/growth differential [6/]	0.9	0.6	0.5	0.0	-0.1	-0.2	-0.2	-0.2	-0.3	-1.1	
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	1.2	0.7	0.2	-0.2	-0.3	-0.3	-0.3	-0.3	-0.3	-1.8	
Exchange rate depreciation [7/]	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	7.8	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/]	-2.3	4.3	-7.8	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.

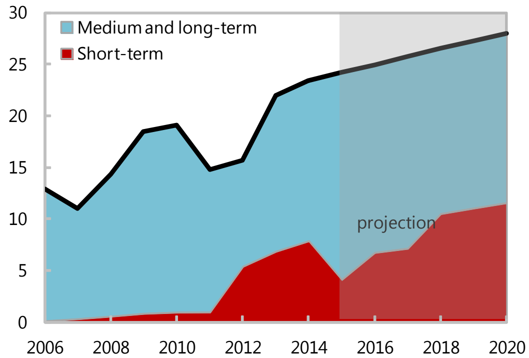
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

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

Composition of Public Debt

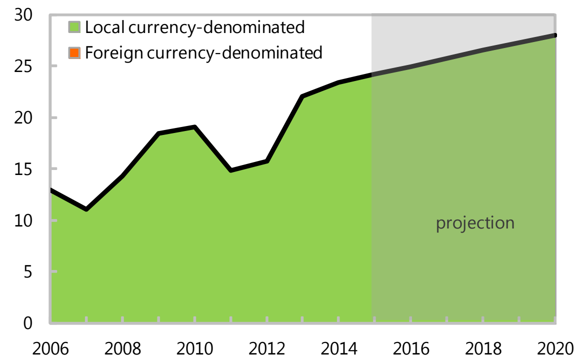
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)



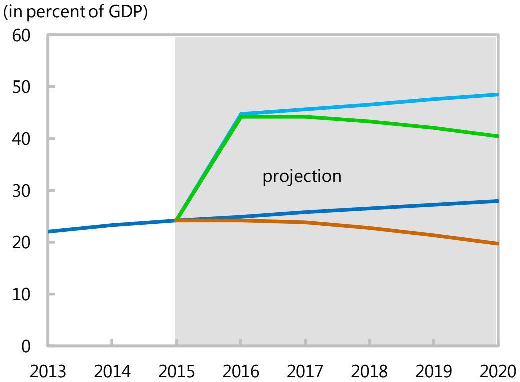
Alternative Scenarios

Baseline

Contingent Liability Shock   Contingent Liability Shock+Adj   Baseline+Adjustment

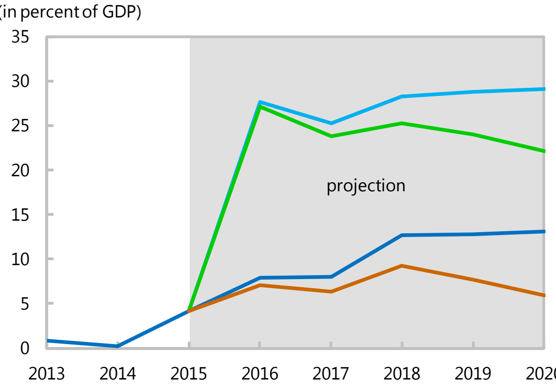
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
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	-0.9	-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	-0.4	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	-20.9	-1.0	-1.0	-1.0	-1.0
Effective interest rate	1.6	0.6	2.5	2.6	2.8	2.9

Contingent Liability Shock+Adj	2015	2016	2017	2018	2019	2020
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	-20.4	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	-0.7	-0.7	-0.7	-0.7	-0.7
Effective interest rate	1.6	0.5	0.5	0.5	0.5	0.5
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

April 21, 2016

STAFF REPORT FOR THE 2016 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In consultation with other departments)

CONTENTS

FUND RELATIONS

(As of March 31, 2016)

Membership Status
Joined: September 23, 1992; Article VIII

General Resources Account	**SDR Million**	**Percent of Quota**
Quota	49.20	100.00
Fund holdings of currency	37.05	75.30
Reserves tranche position	12.15	24.70

SDR Department	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	15.53	100.00
Holdings	8.77	56.47

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 19–January 28, 2015, and the consultation was concluded on March 6, 2015 (IMF Country Report No. 15/94).

FSAP Participation

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

Technical Assistance

Year	Department/Purpose
1997	STA Multi-sector assistance
2004	STA Monetary and financial statistics
2005	MFD Deposit insurance
2008	STA GDDS metadata development
2009	LEG AML/CFT
2011	STA National accounts statistics
2012	STA Government finance statistics
2012	STA Monetary and Financial Statistics
2013	STA Balance of Payments Statistics
2014	FAD Expenditure Policy
2016	MCM Cassa di Risparmio Bank Restructuring

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 April 11, 2016)

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 2004–15, as well as the budget for 2016. 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 April 11, 2016)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange Rates	4/11/16	4/11/16	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Q1 2015	Dec 2015	Q	Q	Q
Reserve/Base Money	Q1 2015	Dec 2015	Q	Q	Q
Broad Money	Q1 2015	Dec 2015	Q	Q	Q
Central Bank Balance Sheet	Q1 2015	Dec 2015	Q	Q	Q
Consolidated Balance Sheet of the Banking System	Q1 2015	Dec 2015	Q	Q	Q
Interest Rates[2]	Q2 2014	Dec 2014	Q	Q	Q
Consumer Price Index	Dec 2015	Mar 2016	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	2014	Nov 2015	A	A	A
GDP/GNP	2014	Nov 2015	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.

Statement by Mr. Carlo Cottarelli, Executive Director for the Republic of San Marino and Ms. Marta Spinella, Advisor to the Executive Director
May 6, 2016

The Sammarinese authorities would like to thank staff for the candid and helpful discussions held during the Article IV consultations and for the valuable recommendations and tailored advice in the Report and Selected Issues Paper. They broadly concur with staff's analysis and, as in the past, plan to make good use of the accurate and detailed Fund's recommendations.

Overview

In the wake of the 2008 global crisis, the Sammarinese economy and financial sector were hit by several concurrent shocks. Primarily of external origin, such as Delta Group resolution, the shocks also highlighted the weakness of an outdated banking business model. As a result, GDP contracted by a third and the authorities were forced to intervene in the banking sector and financial market, promoting a substantial consolidation of the banking system and directly recapitalizing the largest and oldest bank, Cassa di Risparmio di San Marino (CRSM), of systemic relevance. The country's large public financial buffers helped cushion the impact of the shocks and cope with the significant decline of tourism and export revenues, in the context of a deteriorating external environment.

At the height of the crisis, the authorities engaged in a comprehensive and deep reform process designed to stabilize and then revamp the economy, based on rethinking the economic strategy while consolidating public finances.

In the span of a few years, the country, is now on the road to recovery and stabilization, though still confronted with downside risks. International relations have substantially improved: in 2014 Italy included San Marino in its "white list"; in 2015 the European Union started the association agreement negotiations and MoneyVal praised San Marino's progress in reforming the AML/CFT framework, which led, in April 2015, to the inclusion of San Marino in the Italian list of jurisdictions adopting AML/CFT measures deemed to be compliant with international and EU standards. At present, business opportunities with the global community as a whole are expected to further and consistently increase.

The authorities are mindful of the risks the Sammarinese economy is facing, amplified by its small scale, openness and capacity constraints. Hence, they remain fully committed to continue on their reform path and broaden their agenda. San Marino is fully committed to continue complying with international transparency standards, actively participating in international fora, and fully endorsing best practices and standards in the financial system.

Macroeconomic Outlook

In 2016, as in the previous year, the economy is projected to grow at a moderate pace (1-$1^{1/4}$ percent), validating the positive trend boosted by the implementation of industrial sector and labor market reforms.

The diversification of the economy remains a high priority on the country's reform agenda: establishment of a techno-scientific park, niche tourist initiatives, expansion of existing tourism infrastructures, further developments in the cultural offer, are all sizeable expansion plans, which might need to be developed with the material support of foreign counterparts.

Given San Marino's capacity constraints, the authorities are cognizant that smooth, continuous and consistent cooperation with foreign (especially neighboring) partners is of the essence to effectively revamp the economy. Many international partnerships on critical projects are being developed or consolidated and the authorities are relentlessly working to endow the country with a flexible and business-friendly set of rules that could attract stable investments.

Fiscal Policy

Despite the unprecedented challenges posed to public accounts by the needed interventions in the financial sector and the consequent fall in government deposits, the authorities consistently maintained fiscal discipline. Public debt has currently declined to 19 percent of GDP after a peak of 21 percent and the reforms adopted since 2014 – subsequent to the spending review conducted with technical assistance from the IMF – brought sizeable results.

The public sector underwent a profound and systematic re-organization which resulted in a substantial cut to the wage bill. In the short term, the fiscal package on public wages maintains incentives for early retirement coupled by a low turnover ratio, which should further reduce public sector employment and the wage bill.

As for the public pension system, an *ad hoc* working group has been established to work on a reform that would ensure viability to the system while preserving generational neutrality. The authorities acknowledge that the new system needs to be built on solid sustainability grounds to avoid funding shortages and/or public contingent liabilities. The appointed experts are expected to deliver a cost-effective and socially acceptable package by the end of 2017.

Some progress was also achieved in streamlining health expenditure, in line with the spending review recommendations, even if the work in this field is more challenging as the health care system has become increasingly complex over time as many activities were outsourced.

The most relevant measure to be adopted shortly is the introduction of VAT. Thanks to the almost complete digitalization of the tax administration system – that among other benefits dramatically increased the level of compliance – the authorities are confident that the introduction of VAT will not cause major technical difficulties. The new regime should enter into force in 2017, following a long and complex dialogue with all interested stakeholders, and is expected to be initially neutral with respect to tax revenues, while improving the efficiency of the tax system and, over time, enhancing tax compliance. The VAT rates have not been finalized yet, but, most likely there will be two or three different rates for different product categories with the highest rate expected to be lower than the Italian equivalent.

Financial Sector

The capitalization of the Sammarinese banking sector, with the exception of CRSM, is in line with supervisory regulatory requirements; the banking system liquidity situation, despite the pressures related to the Italian Voluntary Disclosure program, does not reveal, at this time, systemic risks. The crisis legacy remains heavy, as the level of NPLs is still high. The authorities are aware of the challenges facing the banking system and stand ready to strengthen regulatory and supervisory standards and facilitate the transition to a new phase of stabilization and growth.

The Selected Issues Paper underlines a number of critical issues that need to be addressed. The authorities agree with most of the findings in the paper and do appreciate the dialogue with the Fund's staff on these matters. However, they believe the overall tone of the document is too negative and does not adequately reflect the severe capacity constraints in terms of human and financial resources that San Marino faces. The authorities believe that some of the suggested measures require careful assessment as to their macroeconomic impact and broad ownership to ensure successful implementation and positive outcomes. Similarly interventions to instill health and vibrancy to the national banking system require also careful assessment and broad ownership. The newly appointed senior management of the Central Bank has started working with the Bank's staff to enhance supervisory and regulatory capacity in line with international best practice and foster a healthy and vibrant financial sector.

Coming to specific actions: the authorities continue to see merit in conducting individual Asset Quality Reviews on the largest banks, most likely during the already planned on-site inspections.

The fourth intervention on CRSM regulatory capital underscored again the urgency to strengthen the largest Sammarinese bank and put it on a path to full recovery expeditiously. The authorities recognize the risks arising from the contingent liabilities related to this last financial rescue. Those risks were weighed against the major risk of a systemic bankruptcy. Work is underway to minimize in the future the state commitment in CRSM, with the aim of completely dismissing its participation in the bank, once it has been restructured and brought back to profitability. The government has received technical assistance from the Fund on this critical issue and is carefully evaluating the related recommendations.

On the way forward, given the above-mentioned capacity constraint and the willingness to strengthen the system as swiftly and expeditiously as possible, the authorities continue to highly value in-depth technical discussions with Fund staff on the best way to improve the banking resolution framework and implement Basel III supervisory requirements. The work is underway and the Central Bank stands ready to play a crucial role in enhancing regulation and supervision, although at this juncture it would need additional resources and funds to fully fulfill its tasks.

After MONEYVAL and the EU Commission acknowledged San Marino's progress in advancing the AML/CFT legal framework towards full compliance with the FATF requirements and the European AML/CFT Directives and regulation, the country has started to work on a national risk assessment program which will further strengthen the implementation and enforcement of the regulations. San Marino is also continuing to work on the implementation of the OECD program for the automatic exchange of tax information.

Structural Reforms

The Sammarinese authorities are aware of the critical importance of providing the country with a modern, wide-ranging and effective new business model. To this end, they have worked unremittingly to improve the market sentiment towards San Marino, strengthen its accountability and transparency and, ultimately, establish a new course for its future development.

These underlying objectives shaped the spending review, tax reform, progress in anti-money laundering issues, as well as scientific and cultural scheme currently in progress. At the same time, the authorities adopted specific measures to improve the business environment and ease access to the labor market. Since the law on e-commerce was approved, the number of enterprises active in product scouting and basic e-commerce services increased dramatically.

The high-tech business incubator established to facilitate the development of a scientific and technological park multiplied its connections with highly reputable researchers and universities, paving the way for the establishment of joint-research projects.

Following on the programs launched after the consultancy of Prof. Ichino, a prominent expert on labor market issues, vocational and training programs have continued to be promoted. *Ad hoc* rules were adopted to ease the recruitment of specialized workers and thus facilitate the reduction of human resources constraints given the size of the country.

The Selected Issues Paper provided additional food for thought on specific regulatory limitations that might hamper a smooth functioning of the market and, even though the authorities consider the Sammarinese judicial system overall effective and efficient, Fund recommendations in this area will be, as usual, carefully considered.

The authorities continue also to pay close attention to the opportunity to open the real estate market to foreign investments while preserving the adequate level of safeguard to the territory, considering its peculiarity and dimension.

Among the main priorities are the continuing negotiations for an Association Agreement with the European Union, aimed at completely aligning San Marino with the EU four freedoms' framework, and the finalization of the Memorandum of Understanding between the Central Bank of San Marino and the Bank of Italy. The credit register implementation is underway and the prospects for a swift completion of the exchange of credit information with Italy are very positive developments.

The maintenance of a constructive relationship with Italy is paramount for the Sammarinese authorities, as it reinforces their endeavors to revamp the economy and ensure the well-deserved recognition of all the last years' efforts to free the country from an image of opaque tax-haven, which no longer reflects real conditions.

Finally, the authorities are cognizant of the need to further strengthen statistical information and are committed to resume the work on this issue in cooperation with the IMF and pooling the Central Bank and the Ministry resources at national level.

In conclusion, the authorities want to reaffirm their commitment to implement a reform agenda that promotes an internationally transparent, open, flexible and competitive Sammarinese economy.