INTERNATIONAL MONETARY FUND

IMF Country Report No. 18/101

# REPUBLIC OF SAN MARINO

## 2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SAN MARINO

April 2018

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 2018 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 March 22, 2018 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 March 22, 2018, following discussions that ended on January 17, 2018, with the officials of the Republic of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on March 6, 2018.
- 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.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org  Web: http://www.imf.org
Price: $18.00 per printed copy

**International Monetary Fund**
**Washington, D.C.**

Press Release No. 18/125
FOR IMMEDIATE RELEASE
April 11, 2018

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

**IMF Executive Board Concludes 2018 Article IV Consultation with the Republic of San Marino**

On March 22, 2018, 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 rebounded in 2016, on the back of recovering domestic demand and important gains in employment. However, the growth momentum slowed in 2017 amid financial sector uncertainties around a sizable loss at the largest bank and a closure of a small bank.

Only moderate growth is projected in the near and medium term. The economy is projected to grow at 1.3 percent in 2018, driven by domestic demand. Private consumption is expected to recover gradually, and an externally-financed investment project will add a significant boost to investment, which otherwise lacks support from the deleveraging banking sector. Unresolved banking sector vulnerabilities could weight on growth prospect.

San Marino continues to pursue the path of internationalization and strives to improve transparency and the business environment. Despite recent initiatives in these areas, challenges remain to diversify the economy beyond banking and support stronger and sustained growth. At the same time, the banking system continues to face weak balance sheets and high non-performing loans while financial sector legacy costs have burdened public finances. Fiscal adjustments are envisaged in the 2018 budget, but the size of deficit and public debt is highly uncertain until the ongoing update of the Asset Quality Review is completed and identifies the full cost of banking sector repair.

[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.

## Executive Board Assessment[2]

The Executive Directors welcomed San Marino's recovery in economic activity in 2016, but noted that momentum slowed in 2017 and considerable challenges remain to address banking system vulnerabilities, which continue to weigh on growth prospects. In this regard, Directors concurred that a comprehensive strategy and decisive actions are needed to safeguard financial stability and limit further costs of the banking sector clean-up to public finances. In addition, they encouraged measures to preserve debt sustainability, and structural reforms to diversify the economy and support growth. Directors emphasized that the reform agenda is demanding and requires strong commitment from all stakeholders.

Directors stressed the importance of restoring banking sector soundness and dealing with the very high stock of nonperforming loans (NPLs). They urged the authorities to complete the recently initiated update of the Asset Quality Review (AQR), noting that the AQR is critical in clarifying the cost of banking sector repair. The process ahead should include upfront loss recognition, prompt bank recapitalization, and reduction of NPLs. Directors considered that a credible strategy for Cassa di Risparmio della Repubblica di San Marino (CRSM) should entail restructuring to return the bank to viability. At the same time, they underscored the need to strengthen central bank functions and bank oversight to mitigate future risks and to adopt high standards of governance, accountability, and transparency.

Directors agreed that a fiscal strategy is needed to safeguard debt sustainability while securing resources for pro-growth policies. Although the fiscal cost of bank recapitalization is highly uncertain, Directors saw the need for sustained fiscal measures, including increasing tax revenue through reform of indirect taxation, and improving the quality and efficiency of spending. They noted that pension reform could help free resources for other areas and saw scope for better prioritization within the current reform proposal. Directors also noted that developing debt management capacity while establishing access to external financing would help enhance the government's ability to respond to shocks.

Directors encouraged structural reforms to improve the business environment, reduce the cost of doing business, and increase labor market flexibility to diversify the economy beyond the financial sector and attract more foreign investment. They welcomed the progress made on the AML/CFT agenda and encouraged the authorities to continue improving the effectiveness of measures to safeguard financial integrity, including by strengthening risk-based supervision of banks.

Directors welcomed the recent initiative to compile balance of payments statistics and encouraged the authorities to continue improving data provision and compliance in line with international standards.

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

## San Marino: Selected Economic Indicators, 2014–18

| | 2014 | 2015 | 2016 | Projection 2017 | Projection 2018 |
|---|---|---|---|---|---|
| **Activity and Prices** | | | | | |
| Real GDP (percent change) | -0.9 | 0.6 | 2.2 | 1.5 | 1.3 |
| Unemployment rate (average; percent) | 8.7 | 9.2 | 8.6 | 8.0 | 7.4 |
| Inflation rate (average; percent) | 1.1 | 0.2 | 0.6 | 0.9 | 1.0 |
| **Public Finances** (percent of GDP) 1/ | | | | | |
| Revenues | 23.2 | 21.4 | 21.8 | 21.1 | 21.8 |
| Expenditure | 22.4 | 21.7 | 22.1 | 21.4 | 22.1 |
| Overall balance | 0.8 | -0.3 | -0.3 | -0.3 | -0.3 |
| Government debt | 19.6 | 20.3 | 22.5 | 56.6 | 55.5 |
| **Money and Credit** | | | | | |
| Deposits (percent change) | 4.0 | ... | ... | ... | ... |
| Private sector credit (percent change) | 1.0 | ... | ... | ... | ... |
| Net foreign assets (percent of GDP) | 5.6 | -3.9 | ... | ... | ... |
| **External Accounts** (percent of GDP) | | | | | |
| Balance of goods and services | 32.6 | 32.2 | 32.8 | ... | ... |
| Gross international reserves (millions of U.S. dollars) | 392.0 | 367.2 | ... | ... | ... |
| **Exchange Rate** (average) | | | | | |
| Euros per U.S. dollar | 0.75 | 0.90 | 0.90 | 0.89 | 0.82 |
| Real exchange rate vis-à-vis Italy | 100.9 | 101.0 | 101.6 | 101.4 | 102.4 |
| **Financial Soundness Indicators** (percent) | | | | | |
| Regulatory capital to risk-weighted assets | 11.4 | 12.7 | 13.6 | ... | ... |
| Bad loans to total loans | 16.1 | 18.5 | 18.7 | ... | ... |
| Loan loss provision to total loans | 30.3 | 28.6 | 26.6 | ... | ... |
| Return on equity (ROE) | -21.4 | -9.0 | -10.5 | ... | ... |
| Liquid assets to total assets | 32.4 | 29.8 | 29.5 | ... | ... |
| Liquid assets to short-term liabilities | 65.4 | 58.9 | 59.1 | ... | ... |

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

1/ For the central government.

# REPUBLIC OF SAN MARINO

## STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

March 6, 2018

## KEY ISSUES

**Context:** The economy rebounded in 2016, but there were some signs of slowing momentum amid deepened financial sector uncertainties triggered by a sizable loss at the largest bank and a closure of a small bank in 2017. There is high uncertainty about the budget and the level of public debt as the final cost of banking sector repair will depend on results from the recently initiated update of the Asset Quality Review (AQR). Banking sector legacy issues continue to pose considerable challenges.

**Key policy recommendations:**

- **Financial sector policy.** Develop and implement a coherent financial sector strategy. Complete the AQR update, followed by upfront loss recognition and prompt recapitalization. Restructure the largest bank to make it viable, including by changing its business model and reducing high operating costs. Accelerate NPL resolutions. Improve accountability and governance in the financial sector, and strengthen central bank structure and operations, including for bank oversight.

- **Fiscal policy.** Develop a fiscal strategy aimed at ensuring debt sustainability and supporting durable growth. Create fiscal space through reform of indirect taxation and targeted pension reform. Contain spending and improve its quality. Develop debt management capacity and diversify financing options.

- **Structural policy.** Further improve the business environment, including reducing red tape, to help diversify the economy. Continue the efforts to enhance international cooperation and transparency. Strengthen data provision.

**Traction of Fund advice:** The AQR launched in late 2016 became outdated, but the central bank recently initiated an update to complete the diagnostic. In line with past recommendations, a domestic credit registry has been launched recently. A partial liberalization of the labor and real estate markets has been legislated, but the reform of indirect taxation has not advanced sufficiently. The AML/CFT regulatory framework has been recently updated with the aim of meeting international standards. Work has started to compile balance of payments (BOP) statistics.

Approved By
**Mahmood Pradhan (EUR) and Yan Sun (SPR)**

Discussions for the 2018 Article IV consultation took place during January 8–17, 2018. The staff team comprised Ms. Shirono (head), Ms. Meng, Mr. Podpiera (all EUR), Mr. Hansen (FIN), and Mr. Monaghan (MCM). Mr. Spadafora (OED) attended the meetings, and Mr. Leipold (OED) participated in the latter part of the mission. The mission met with the heads of state, Finance Minister, Central Bank Director General, other cabinet members, senior officials, private sector representatives and social partners. Ms. Burova and Mr. Velazquez-Romero (all EUR) supported the mission from headquarters.

## CONTENTS

**ANNEXES**

# CONTEXT: PRESSING NEED FOR LASTING SOLUTIONS

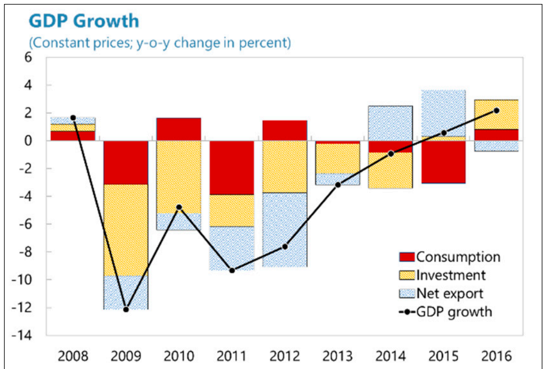
*San Marino, a euroized microstate enclosed in Italy, experienced a severe recession during 2008–14, triggered by a series of shocks, leading to an implosion of the financial sector built upon bank secrecy and tax haven status. After contracting by more than a third, the economy started to grow in 2015 and rebounded in 2016. However, progress in bank balance sheet repair has been limited while financial sector legacy costs have burdened public finances. Prolonged weaknesses in the banking system continue to weigh on growth prospects.*

1. **Output growth rebounded in 2016, supported by domestic demand, although momentum slowed in 2017 amid deepened banking sector uncertainties** (Figure 1). According to preliminary data, GDP grew by 2.2 percent in 2016 with growth drivers rotating towards domestic demand. Both consumption and investment contributed positively to growth. In 2017, high-frequency indicators suggest that growth slowed to 1.5 percent (Figure 2), consistent with estimates based on employment gains using Okun's Law:

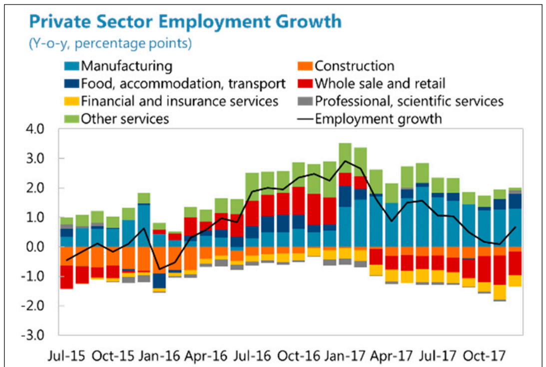
- Employment growth decelerated slightly in 2017, in part due to the slowdown in the retail trade sector. The manufacturing sector added most jobs while the financial sector continues to downsize due to the ongoing bank restructuring (see also Box 1).

- In 2017, the recovery in consumption and investment has been weak as the number of enterprises, especially in wholesale and retail, continues to decline. The number of new car registrations have stabilized in recent months and remain below the pre-crisis level.

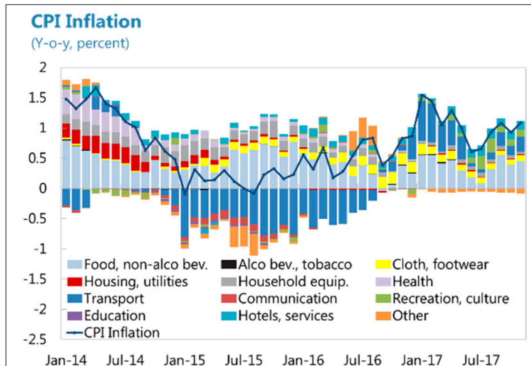
- Headline inflation has been volatile, driven by swings in oil and food prices. Core inflation slowed y-o-y in 2017, suggesting weakening pressures from domestic demand.



Sources: UPECEDS and IMF staff calculations. Preliminary revised data.



Sources: UPECEDS and IMF staff calculations.



Sources: UPECEDS and IMF staff calculations.

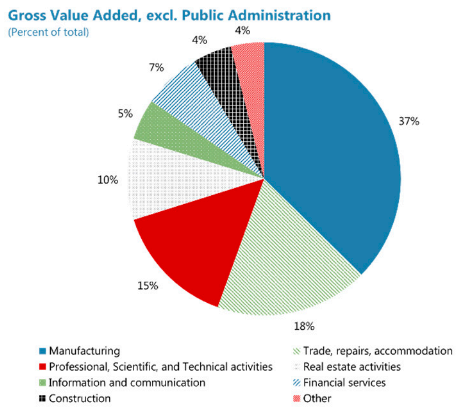
## Box 1. The Sammarinese Economy

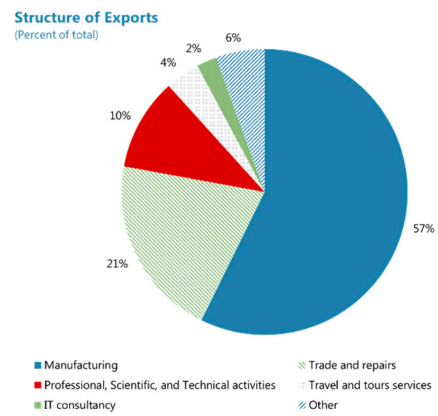
The structure of the Sammarinese economy corresponds to an industrialized, open economy with a significant service sector. Aside of the public administration, which accounts for about 15 percent of the gross value added, the economy stands on two major production and export pillars:

- *Manufacturing*, accounting for the largest part of the production and export, includes diversified manufacturing across metal products, machinery, wood products and furniture, textile and leather, food products, and electronics.

- *Services*, especially trade, repair, and accommodation, professional, scientific, and technical services and IT consultancy. Much of these services are also a large part of the export, including advertising, design, tour operators, and management services.

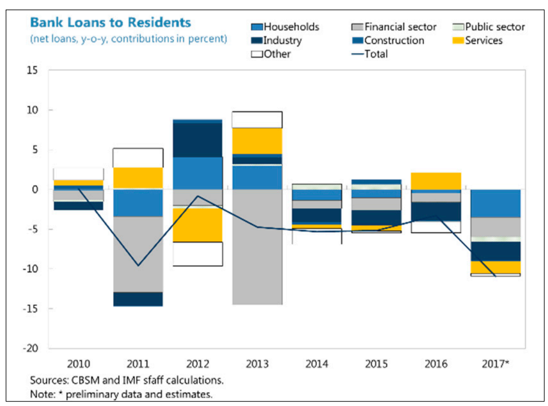
The rest of the economy represents non-tradables: construction, real estate activities, and financial services.




Sources: UPECEDS; and IMF staff.

**2. Credit to the domestic economy declined further in 2017, slowing the real sector activity.** Banks have been deleveraging across all sectors, limiting growth in private consumption and putting pressures on businesses to rely on their own cash flow to finance the current expansion. The lack of leverage opportunities thus puts a limit on the speed of economic recovery.[1]




**3. Banking system fragilities deepened in 2017, with the closure of a small bank and a sizable loss reported by the largest bank:**

- The Asset Quality Review (AQR), undertaken in late 2016 by Boston Consulting Group (BCG), identified capital shortfalls of €266 million (19 percent of GDP) in the banking system in

[1] The impact of overall bank deleveraging on the economy is mitigated by banks deleveraging on both the domestic and foreign loan portfolios, each of which accounts for about a half.

April 2017.[2] Most of this loss was in the largest, mostly state-owned bank, Cassa di Risparmio della Repubblica di San Marino (CRSM). At the same time, Asset Banca, a small bank, was intervened by the Central Bank of San Marino (CBSM) in May 2017, and later merged into CRSM.[3]

- The new management of CRSM, appointed by the government in April 2017, conducted an internal audit applying stricter valuations to legacy loan portfolio (Delta) than the AQR, and reported a loss of €534 million (37 percent of GDP) for the 2016 financial year. In response, the government issued Bank Decree-Law 101, which allows banks to spread losses over up to 30 years, and committed to guaranteeing all liabilities of CRSM except equity and to recapitalizing the bank with public money. Taking advantage of this decree, CRSM booked a loss of €54 million in 2016, reducing immediate recapitalization needs, with the remaining loss to be amortized by the state over 25 years. However, this process significantly delayed the transfer of Asset Banca to CRSM, leaving Asset Banca account holders without access to their deposits for several months until November 2017, when the merger eventually took place.

**4. In addition, central bank management has been in flux.** The CBSM director general (deputy governor), responsible for banking supervision, was dismissed in August 2017. The CBSM president (governor) announced his resignation in mid-September and resigned at end-October. A new director general took office in October 2017, but resigned in the following month. Another new director general was nominated in December 2017. The position of President of the central bank remains vacant although a search is currently underway.

**5. Banking system liquidity was under pressure although it has stabilized recently.** The voluntary disclosure (tax amnesty) for Italian depositors in Sammarinese banks accounted for the bulk of non-resident-led deposit outflows in 2016, but uncertainties regarding the Asset Banca transfer and the large loss reported by CRSM marked periods of liquidity pressures from residents in 2017. Liquidity in the system has gradually fallen close to historical lows. However, pressures have eased from autumn 2017, particularly after partial unfreezing of Asset Banca accounts, and despite the recent decline, the overall level of reserves in the system seems adequate (Annex III).

**6. The trade surplus remained high at around €460 million (32 percent of GDP) in 2016.[4]** Growth rates of exports and imports each picked up to around 4 percent, in line with improved external and domestic demand. More recent data, however, points to some slowdown in both exports and imports.

---

[2] This is based on the current domestic regulations. Under international standards, the amount rises to €486 million (34 percent of GDP). The gap is due to the difference in provisioning and capital requirement rules.

[3] The AQR found the remaining banks to be broadly viable. Although CRSM accounts for about half of the system assets, the losses at CRSM stemmed mainly from a foreign portfolio and thus did not raise contagion concerns.

[4] Trade data are subject to some uncertainty possibly due to factors such as transfer pricing, under-invoicing of imports, and unrecorded cross-border shopping.

**7. The external position is moderately weaker than fundamentals and desired policy** (Box 2).[5] The CPI-based RER against Italy has depreciated marginally from the 2016 peak, reflecting recent inflation slowdown in San Marino. The REER, constructed using weights of major trade partners, points to a similar trend, bringing the REER to about 1 percent above its 10-year average. While price-based indicators have not changed significantly, the stagnant export market share and productivity growth suggest that improving competitiveness remains a key challenge for San Marino.

## Box 2. External Sector and Competitiveness

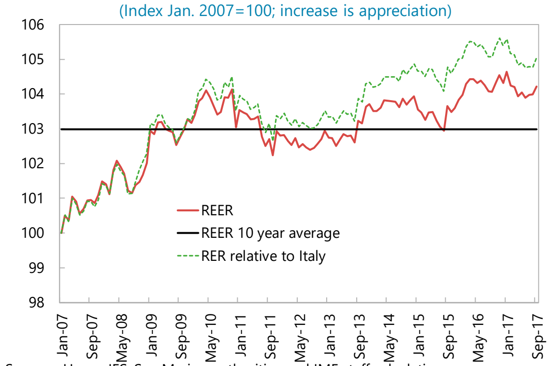
External position remains moderately weaker than fundamentals and desired policy. San Marino needs further reforms to enhance business environment and improve its competitiveness.

**Competitiveness.** Real exchange rate (RER) vis-à-vis Italy has depreciated slightly compared to the peak in 2016, but RER remains about 1.5 percent above the 10-year average. The CPI-based real effective exchange rate (REER), constructed by using trade weights of top five trade partners, follows a similar trend and remains 1 percent above the 10-year historical average.

**Market Share.** The export market share is small compared to its peers in Europe. Although the exports market share increased slightly in 2016, it remains significantly lower than the pre-global financial crisis level.

**CPI Based Effective Exchange Rates relative to Top 5 Trade Partners**

(Index Jan. 2007=100; increase is appreciation)

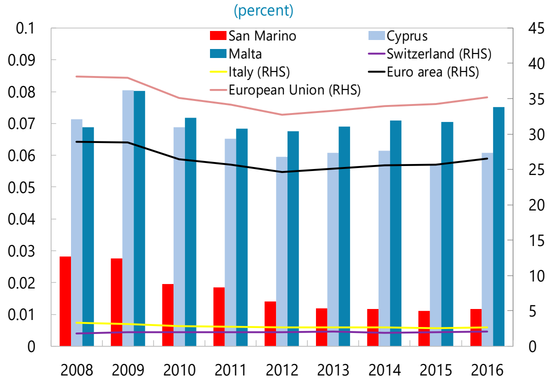



Sources: Haver, IFS, San Marino authorities and IMF staff calculations.

**Doing Business.** Based on the World Bank's Doing Business 2018 report, San Marino's ranking on the ease of doing business fell from 79 to 93 out of 190 countries. Compared to its peers, the main challenges remain in the areas of "getting credit", "protecting minority investors" and "resolving insolvency." In addition, the category of "paying tax", which had the noticeable improvement last year, ranked lower this year.

**Shares in World Exports Market**

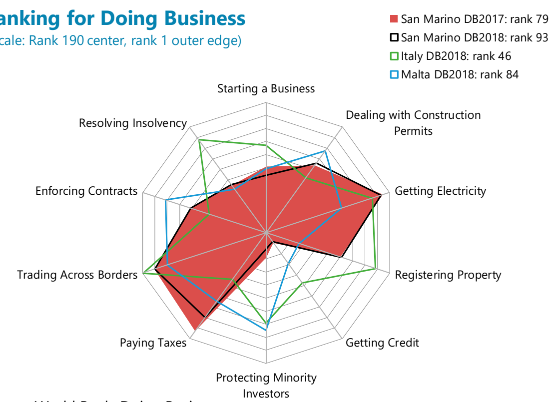
(percent)




Sources: World Economic Outlook; San Marino authorities and IMF staff calculations.

**Ranking for Doing Business**

(Scale: Rank 190 center, rank 1 outer edge)




Source: World Bank, Doing Business.

[5] Inadequate external sector statistics limits scope for conducting the standard external sector assessment.

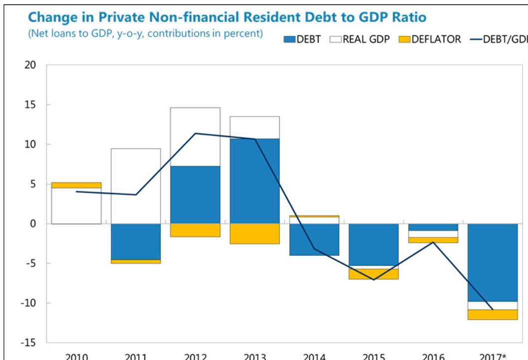
**8. The fiscal deficit was contained in 2016, but debt levels rose due to bank recapitalization.** The deficit was ¼ percent of GDP in 2016, due to higher than expected non-tax revenue. The level of spending was maintained, unlike in previous years when spending cuts were the main adjustment tool. Public debt continued to rise, reaching a still modest 23 percent of GDP in 2016, largely reflecting CRSM recapitalization of €40 million in early 2016.

# OUTLOOK AND RISKS: FLYING LOW AGAINST HEADWINDS

**9. Only moderate growth is expected in the near and medium term.** The economy is expected to grow at 1.3 percent in 2018, driven by domestic demand. While private consumption is expected to benefit from past gains in employment, investment lacks support from the deleveraging banking sector although planned construction of a shopping mall with external funding is expected to give a significant boost to investment. Growth projections, including growth drivers and employment, are consistent with a creditless recovery and reflect the authorities' intention to recapitalize CRSM with public money over 25 years, which will effectively limit CRSM's capacity to make new loans.[6]

**10. The growth outlook is also consistent with continued deleveraging.** The earlier crisis (through declining GDP) significantly aggravated debt burdens of private non-financial residents. Corporate debt remains high, especially in construction. Bank deleveraging has so far taken place mostly through loan repayments by clients and banks' writedowns. Stylized facts suggest that deleveraging is still in the early phase and will likely continue.[7]

Change in Private Non-financial Resident Debt to GDP Ratio




Sources: CBSM and IMF sfaff calculations.
Note: *preliminary data and estimates. Private resident debt includes resident households and NFC.

**11. This baseline scenario is subject to several downside risks** (Annex I):

- *Incomplete banking sector reforms*, including a failure to properly restructure CRSM, could lead to a further loss of confidence in the system and further impair credit provision. Loan performance could further deteriorate, resulting in additional bank recapitalization needs.

- *Rapid increase in fiscal costs related to banking sector repair*, including realization of contingent liabilities such as the conversion of tax credits of banks into government bonds, could place further pressure on public finances.

---

[6] Creditless recoveries are characterized by a rebound in employment and mainly consumption-driven growth (investment contributes only about a third, see IMF WP 1158) while credit continues to decline. The projected growth is tracking the lower bound of historical creditless recoveries.

[7] McKinsey Global Institute, 2010, "Debt and Deleveraging: The Global Credit Bubble and Its Economic Consequences", Exhibit 4.

- *Tighter global financial conditions* due to monetary policy normalization in key economies could result in higher borrowing costs if San Marino seeks external financing while an appreciation of the euro vis-à-vis other currencies would undermine the external competitiveness of San Marino.

***Authorities' Views***

**12. The authorities broadly concurred with staff's assessment of the outlook and risks, although they believe that growth could increase in 2018 due to important investments.** They are cognizant of the urgent need to complete the banking sector repair and implement structural reforms to support medium-term growth. At the same time, they noted that the 2018 budget envisages increased capital spending aimed at supporting growth, and a large investment project consisting of the construction of a luxury shopping mall, which has started this year and will be operational by 2019.

# POLICY DISCUSSIONS: TIME FOR ACTION

*Maintaining financial stability and restoring banking sector soundness remain key priorities. Public support of the banking sector needs to come with improvements in accountability and oversight. Fiscal adjustments are envisaged but public debt prospects will depend on the final fiscal costs of repairing the banking system. Continued structural reforms, including reducing red tape, will help reorganize the economy.*

## A. Financial Sector Policy

**13. The authorities responded to the large loss reported by CRSM and the closure of Asset Banca by issuing a series of bank decrees during June–October 2017:**

- To address Asset Banca issues (Decree-Laws 72 and 80), reducing the deposit guarantee to €50,000 and freezing the remaining deposits for three years with an interest rate 1.5 percent per annum, and transferring Asset Banca in liquidation to CRSM with a recognition of tax credits for the losses imposed on CRSM (Decree-Laws 88 and 89);

- Enhancing liquidity through provision of state guarantees to facilitate emergency liquidity assistance by the CBSM and granting banks the option to convert accumulated tax credits into government bonds (Decree-Law 93);

- Securing up to €200 million of state borrowing from pension fund deposits, to recapitalize CRSM (Decree-Laws 94 and 98) and allowing banks to spread losses over up to 30 years (Decree-Law 101).

Decree-Law 101 and conversion of tax credits into government bonds (Decree-Law 93) are not aligned with incentive to restructure banks, and the latter may cost tax payers up to an estimated amount of about €300 million.

**14. Modalities of public intervention in CRSM and Asset Banca fell short of international best practices.** The government assumed the entire loss of Asset Banca and folded it into CRSM, despite scope for burden sharing with subordinated bond holders. CRSM's €54 million loss booked for 2016 was partially addressed by converting €41.4 million hybrid bonds into equity and €8.5 million capital injection in December 2017, with the balance injected in Q1:2018. The remaining loss (€480 million or 33 percent of GDP) was initially planned to be amortized using public money over the next 25 years. This operation makes the total bill for CRSM recapitalization rise to over €700 million (around 50 percent of GDP), but shareholders would not be fully wiped out. This is not the most cost-effective solution for the public sector and facilitates moral hazard. Spreading the loss over 25 years will not unlock resources for new lending, and CRSM will be vulnerable to liquidity shocks as a large share of assets will remain illiquid. The authorities are currently reviewing the modalities of addressing CRSM's loss and opted for not recording it in the fiscal account until diagnostics are completed and modalities are finalized. At the same time, the authorities are considering purchasing CRSM subordinated debt held by the pension fund (€35 million) and remaining shares from one of the private shareholders (about €3 million).[8]

### State Aid for CRSM

| Year | Recapitalization (€ million) | Of which state funds (€ million) | State funds (% of GDP) | Notes: |
|---|---|---|---|---|
| 2012 | 80 | 60 | 4.3 | Capital injection (€60 million government's low-interest loan to shareholders). |
| 2013 | 40 | 35 | 2.5 | Subordinated debt (€35 million subscribed by the state social security fund). |
| 2014 | 85 | 85 | 6.1 | Capital injection (government bond issuance, fully subscribed by CRSM). |
| 2016 | 62 | 40 | 2.8 | Tier-2 capital (€40 million government tier-2 hybrid bond issuance fully subscribed by CRSM, €13 million real estate revaluation, and €9 million reserve creation). |
| 2017 (planned) | 54 | 54 | 3.7 | Capital injection (converting €41 million hybrid bonds into equity and €13 million fresh capital). Hybrid bonds conversion and capital injection of €8.5 million out of 13 million took place in 2017. |
| 2018-42 (planned) | 480 | 480 | 30.0 | Loss amortization (capital injection) |
| **Total** | **801** | **754** | **49.3** | |
| | **Contingent liability (€ million)** | | **State funds (% of GDP)** | |
| 2017- | 119 | 119 | 7.9 | Decree-Law 93: Option to convert tax credits to government bonds (€79 million stemming from Asset Banca and past tax credits of approx. € 40 million) |
| **Total including contingent liability** | **920** | **873** | **57.3** | |

[8] Private shareholders consist of two charitable organizations.

**15. The CBSM initiated the process of updating the AQR to finalize the diagnostics of bank capital shortfalls.**[9] The post AQR process, which was expected to take place last year, was significantly delayed due to the turnover of central bank management while the AQR results using the data from mid-2016 became outdated. The update of the AQR is expected to identify capital shortfalls based on more recent data and provide the basis for restructuring and recapitalization plans for the banking system. In the meantime, a medium size bank, comprising about 10 percent of banking system assets, is in the process of being sold to a foreign investor from Saudi Arabia.

**16. A coherent strategy is needed to restore confidence and soundness of the banking system.** Lingering banking sector problems, built up over the last decade, have incurred high costs for the state. A new strategy for the banking sector with permanent solutions is urgently needed to minimize costs to tax payers, safeguard financial stability, and ensure the banking system is viable and contributes to the economy. Key elements of the process ahead should include upfront loss recognition, prompt bank recapitalization, and NPL resolution, supported by measures to improve transparency and accountability, and enhance the financial sector infrastructure. Decisively addressing banking sector problems requires the following actions:

- ***Bank balance sheet repair.*** An AQR update is necessary to identify and address capital shortfalls, followed by recapitalization within a short timeframe. Market-based solutions should be sought, and public capital support should be limited to only viable, systemically important banks, following burden sharing. Bank governance also needs to be strengthened, including risk management, and making new and existing management subject to rigorous fit and proper tests.

- ***Deep restructuring of CRSM.*** CRSM needs to be restructured to quickly restore long-term viability, including by changing its business model, reducing high operating costs, and ensuring prudent lending. The state aid provided during 2012–16 amounts to €220 million (about 16 percent of GDP) and will increase further due to a very large additional loss now being reported. This loss needs to be recognized upfront, and current shareholders and subordinated debt holders should absorb the loss before new capital is injected. Involvement of all stakeholders, including social partners and the state, is essential to reduce CRSM's operating costs to limit further burden on tax payers. CRSM recapitalization and restructuring should be part of a broader strategy that includes returning the bank to private management and ownership to ensure sound governance and robust credit risk management. A first-best solution would be to sell the new CRSM to a large foreign bank to immediately benefit from its treasury, risk management and governance expertise. As an outright sale may be difficult in the near to medium-term, an alternative option could be to establish a bridge bank and outsource its management to a large foreign bank that is given an option to purchase the bank outright in the medium-term. The residual assets arising from CRSM restructuring should be liquidated by a competent NPL manager.

- ***Managing NPLs.*** Banks should be subject to ambitious and credible plans aimed at significantly reducing NPLs over the medium term, including through outsourcing loan collection and workout. These efforts should be supported by regulatory, tax, and legal reforms, including removing

[9] The AQR update will be conducted by an external consulting firm.

remaining tax disincentives to NPL disposals and enhancing effectiveness of the insolvency and enforcement regimes. The recent launch of a domestic credit registry is a welcome step to help restore payment culture, and harmonization to facilitate information exchange with Italy should be completed. The partial opening of the real estate market to nonresidents will help support collateral values during asset recovery. A formal asset classification and provisioning framework should be considered to ensure that banks have adequate capital in the future to tackle NPLs.

**17. Improvements in accountability, governance, oversight and communication should be a prerequisite to a further use of state resources to support the banking system.** To address banking sector problems more effectively, a financial stability committee should be established to improve coordination between the government and the central bank, especially for communication, and decision making within their respective mandates. A memorandum of understanding between the government and the central bank would help clarify responsibilities and a protocol for information exchange. The recently established financial stability task force, consisting of the government, central bank, and banks, is nevertheless helpful to facilitate dialogue and understanding among stakeholders.

**18. Strengthening bank oversight and central bank infrastructure is crucial to secure financial stability going forward:**

- ***Crisis response capability.*** The CBSM should establish a dedicated bank resolution unit staffed with professionals to develop its policies and processes to deal with vulnerable banks including a prompt corrective action framework, lender of last resort facilities, systemic impact assessments, bank viability assessments, and bank intervention, resolution, and liquidation.

- ***Supervision and regulation.*** Regulations and supervision need to be improved to enhance banking system oversight. Improved data collection and enhanced oversight of bank lending standards during regular on-site visits would help improve the understanding of bank-specific risks and promote compliance with regulation. Developing capacity to monitor systemic risks is key to ensure financial stability. A regular publication of a concise, well-targeted financial stability report both in Italian and English could be a useful communication tool to present CBSM's assessment and policy intentions to the public.

- ***Central bank reform.*** Key suggestions of the 2016 internal audit of CBSM functions and structure should be implemented. The CBSM powers and mandate should be reviewed, and CBSM should be made more effective by separating non-core activities, simplifying banking supervision structure into off-site and on-site units, centralizing supervisory data, unifying legal and regulatory activities, and creating macro-analysis and communication units. Adopting the highest standards of central bank independence, governance, accountability and transparency as identified by the Bank of International Settlement is also key.

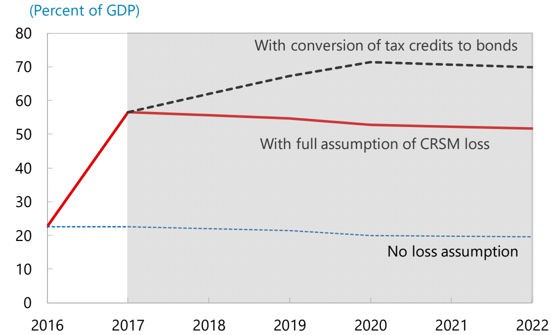
***Authorities' Views***

**19. The authorities agreed that permanent solutions to banking sector vulnerabilities are needed.** They acknowledged that drafting a financial sector strategy as well as establishing a decision-making financial sector committee will be key to support the process. The CBSM launched an AQR update that will serve as a base for finding sustainable solutions for banks with shortcomings. The government, as the main shareholder of CRSM, is aware of the need to recognize losses, recapitalize CRSM and take steps to ensure the bank can make independent commercial decisions, including restructuring that will swiftly bring the bank to profitability. Plans are under way to support a system-wide NPLs cleanup and information exchange with the Bank of Italy. The authorities recognized the need to reorganize the CBSM to enhance banking supervision, using also findings from the CBSM internal audit.

## B. Fiscal Policy

**20. Public finances have been managed to limit the deficit in recent years, but public debt is bound to rise further due to bank recapitalization costs.** While specific modalities are yet to be defined, the state's assumption of the currently reported amount of CRSM legacy loss implies a substantial rise in public debt to 57 percent of GDP, posing new debt management challenges (see Box 3 and Selected Issues Paper). If contingent liabilities from conversion of tax credits into government bonds materialize, public debt could rise even further. Some adjustments to limit the deficit have been implemented in the 2017 revised budget, including one-off measures to cancel non-mandatory expenditure and strengthen tax collection efforts, while planned capital spending of €10 million for 2017 was also cancelled.

**Public Debt Dynamics**
(Percent of GDP)




Sources: IMF staff estimates.

**21. The 2018 budget further envisages fiscal adjustment measures, including extraordinary tax measures and some current spending cuts.**[10] These adjustments imply a close to balanced budget for 2018, and declining debt-to-GDP ratio in the medium-term. However, the budget and level of public debt are highly uncertain, depending on the final costs of bank recapitalization which will be clarified by the ongoing AQR update.

**Estimated Fiscal Costs of Banking Sector Repair 1/**

| | € million | % of GDP | |
|---|---|---|---|
| CRSM capital injection | 13 | 1 | €13 million out of the €54 million CRSM recapitalization need in 2017 is planned to be met by capital injection by the government. |
| CRSM legacy loss | 480 | 30 | €480 million (=534-54) is initially announced to be amortized over 25 years by the government. However, modalities are yet to be finalized. The baseline scenario treats this as part of public debt recognized in 2017. |
| **Subtotal** | **493** | **31** | |
| Contingent liability (estimate) from Bank Decree-Law 93 | 300 | 20 | Estimated amount of potential conversion of tax credits into government bonds. This option could be triggered by any banks which have accumulated tax credits in the past. |
| **Total** | **793** | **51** | |

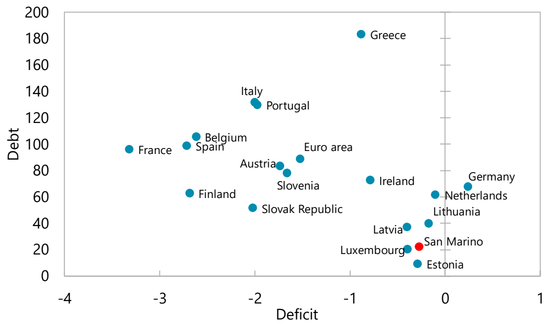
1/ This is based on currently available information and staff estimate. Total final costs are highly uncertain.

[10] The government aims at cutting current expenditure by 2.5 percent during 2018, but only 0.6 percent has been included in the budget so far. The remaining savings are planned to be identified in coming months.

## Box 3. Public Debt Dynamics

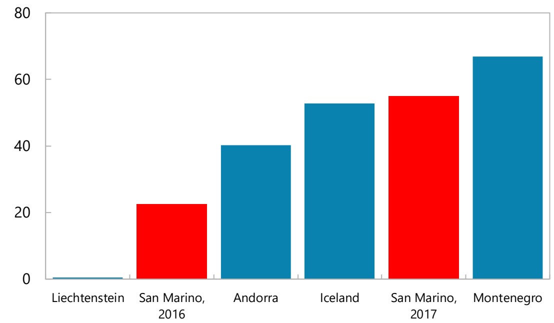
Based on the government's current commitment to recapitalize CRSM with public money, San Marino's public debt is projected to rise to more than 50 percent of GDP in 2017. This level is lower than many of its euro area peers, but high compared with other European microstates. Given San Marino's untested access to global markets and underdeveloped capacity to manage debt, commonly used debt thresholds (85 percent and 75 percent for developed and emerging markets, respectively) may not be appropriate benchmarks for San Marino.

**Government Debt and Deficit: San Marino and Euro Area, 2016**
(Percent of GDP)




Sources: *World Economic Outlook (WEO);* and IMF staff calculations.

**General Government Debt in European Microstates**
(Percent of GDP)




Note: A microstate is defined as in Iman (2010). EA countries are excluded.
Sources: *World Economic Outlook (WEO);* Standard and Poor's; Fitch; and IMF staff calculations.

Targeting both debt level and deposit accumulation may provide a useful medium term fiscal anchor for San Marino. Staff's scenario analysis suggests that aiming at the debt level of around 50 percent in 2022 would be manageable given that projected interest payment would remain relatively contained (comparable with other European countries) even though it will rise to around 4 percent of revenue from the current low level of 1.4 percent (see Selected Issues Paper). Targeting 50 percent of debt-to-GDP ratio would also allow for gradually rebuilding deposits buffers at the same time, to cover at least two to three months of spending. Altogether, achieving these debt and deposit targets by 2022 will require an annual fiscal adjustment of around 0.8–1.1 percent of GDP relative to the baseline scenario. Such adjustments would create useful fiscal buffers and some room for the debt ratio to rise in the event of an economic downturn (text table). However, there is currently high uncertainty about the level of debt and the size of deficit, and necessary fiscal adjustments and an appropriate level of debt target will need to be recalibrated as new information becomes available.

In addition, if the contingent liability of converting tax credits into bonds materializes, or if fiscal costs of banking sector repair turn out higher than currently known, more ambitious fiscal adjustments may be necessary. Also, the analysis above assumes no impact on the GDP path of fiscal consolidation for simplicity, but a higher negative impact on growth would increase the required consolidation to attain the given debt to GDP level.

**Necessary Annual Fiscal Adjustment**
(Percent of GDP)

| | Debt ratio in 2022 w/o adjustment | Debt reduction to: | Additional deposit build-up (months of annual expenditure) | | | | |
|---|---|---|---|---|---|---|---|
| | | 50 percent of GDP | 1 month | 2 months | 3 months | 4 months | 5 months |
| Baseline | 51.7 | 0.4 | 0.4 | 0.7 | 1.1 | 1.4 | 1.8 |
| with conversion of tax credits into bonds | 69.9 | 4.1 | | | | | |

Notes: An interest rate of 1.5 percent on the CRSM and tax credits obligation is assumed.

**22. New pension reform proposals have been presented recently.** In total 30 potential measures, including lowering the replacement rate and improving pension fund management to increase returns, are currently under public consultation.

**San Marino: Selected Pension Reform Proposals**

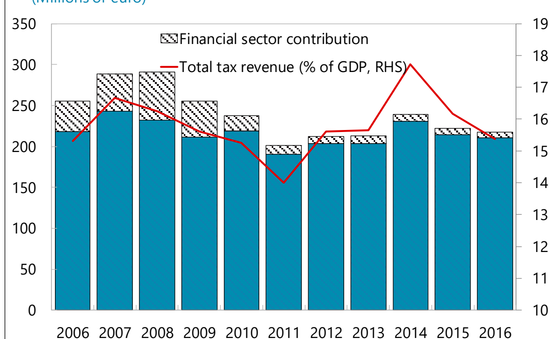
| | |
|---|---|
| 1 | Introduce a part-time retirement mechanism for those nearing retirement (reduced pension benefits and contributions) |
| 2 | Automatic adjustment of retirement age to life expectancy |
| 3 | Abolish the 20 percent tax exemption on pensions and gradually limit it to pensions less than EUR 3,000 |
| 4 | Allow retirees to work during retirement and contribute to the system |
| 5 | Reduce redistributive element of the current system, by introducing a cap on social security contributions to discourage high-income individuals from retiring abroad |
| 6 | Allow for reduced contributions to the redundancy fund (i.e., solidarity contribution only) for an indefinite period of time with no eligibility for benefits during that period |
| 7 | Reduce social security contributions for new entrants into the labor market |
| 8 | Tighten the requirements for a "seniority pension" |
| 9 | Ensure equity across generations by lowering the replacement rate of older generations |
| 10 | Improve pension fund management to increase returns |

Source: San Marino authorities.

**23. A fiscal strategy should aim to ensure debt sustainability and support growth.** It should entail greater revenue collection, reviewing the level and quality of spending, enhancing debt management capacity, and diversifying financing options. The 2018 budget already appropriately contains some of these elements:

- ***Increasing tax revenues.*** San Marino has lost a significant amount of revenue from the financial sector since the global financial crisis as banking system assets shrank significantly.[11] Spending cuts have been the main adjustment tool in recent years, but higher revenue is necessary to ensure fiscal sustainability in the face of banking sector legacy costs falling on the state budget. San Marino's relatively low tax collection compared with its European neighbors should allow for increasing tax revenues without jeopardizing competitiveness. The planned tax measures, including the re-introduction of a wealth tax, will help increase revenues, but should be complemented with permanent measures to mobilize revenues.[12] In particular, reform of indirect taxation should play a pivotal role in raising revenues in the medium term. The authorities now aim to introduce a VAT by 2020, and have recently appointed an expert group to prepare a specific reform proposal with a draft law to be discussed at Parliament by mid-2018 and approved by the end of the year.

**Tax Revenue**
(Millions of euro)



Sources: San Marino Ministry of Finance and Fund staff calculations.

- ***Containing expenditure and improving the quality of spending.*** A further modest reduction in the wage bill could be explored as its share in current spending remains higher than euro area countries. The recently conducted spending review will help identify further areas for savings. Increased capital spending annually for 2018–19, which is mostly used for infrastructure

[11] During 2006–09, financial sector contribution to tax revenues was roughly €50 million annually.

[12] The wealth tax is estimated to generate €15 million additional revenue annually.

investment, will help support growth. Ensuring social security is self-financed would free resources for other priority areas. However, the current pension reform proposal is complex with multiple objectives and would benefit from prioritization to increase its effectiveness, including focusing on changing the pension formula by moving to life-time wages and accelerating an increase in retirement age.

- ***Developing debt management capacity.*** Debt management capacity needs to be enhanced to effectively record, monitor, and manage higher public debt to ensure public debt sustainability and accurate and transparent reporting.

- ***Diversifying financing options.*** Establishing access to external financing for the sovereign would enhance the government's ability to respond to shocks. The authorities should start exploring the necessary process and steps, including for an external private placement of syndicated loan.

***Authorities' Views***

**24. The authorities agreed on the need to pursue fiscal adjustments while supporting growth.** They emphasized that the 2018 budget already envisages a balanced budget with adjustment measures while allocating resources for spending to support job and growth. The authorities view the VAT reform and the pension reform as crucial to ensure fiscal sustainability in the medium term. They noted that the government's commitment to absorb the CRSM loss from 2016 are currently not reflected in the public account since the modalities of the operation are not yet finalized.

## C. Structural Reforms

**25. Several structural reform measures have been approved by parliament during August–October 2017.**

- Partial liberalization of the real estate market and introduction of "elective residency" program; and

- "Development Law" entailing a number of measures to increase labor market flexibility and support San Marino's economic development (text table).

**26. Further structural reforms, including reducing red tape, will help reorganize the economy away from the banking system.** The recent change in the hiring process of non-residents is a step towards easing skills shortages and improving productivity through better matches in the labor market. Increased labor market flexibility should be supported by a well-targeted social policy, where benefits are means-tested and linked to training and job search requirements to help unemployed workers engage in the labor market. Further measures to improve the business environment are underway, including creating a one-stop-shop to reduce cost of doing business. These reforms should be aimed at improving efficiency and avoiding additional fiscal costs.

**San Marino: Selected Structural Reform Measures**

| Parliament Approval | Measures |
|---|---|
| August 2017 | **1.** Partial opening of the domestic real estate market to non-residents up to 100 units.<br>**2.** "Elective Residency" program grants a registered residency status to non-residents for purchasing a real estate worth at least €500,000 or depositing €600,000 in a non-interest bearing Sovereign Fund for 10 years. |
| October 2017, "Development Law" | **1.** Allow companies to directly hire non-resident workers by paying 4.5 percent of gross wage for the hiring positions.<br>**2.** Allow to grant open-ended contracts to non-resident workers after 18 months of fixed-term contracts.<br>**3.** Simplifying rules for apprenticeship program application by automatically approving apprenticeship when companies request.<br>**4.** Provide subsidies through the Social Shock Absorber Fund to companies up to 48 months for recruiting and keeping the hired workers in the job-start lists.<br>**5.** Ease requirement for the "Investment for Residency" scheme by reducing the minimum investment requirements to €75,000 annually and €150,000 over two years, and minimum local hiring to 1 or 3 employees, depending on sectors. |

Source: San Marino authorities.

**27. San Marino's continued effort to engage with the international community, strengthen further the AML/CFT framework, and enhance transparency is crucial.** In 2017, San Marino signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (BEPS), which transposes BEPS principles into existing bilateral tax treaties. The recently ratified AML/CFT regulatory update, implementing the AML/CFT Action plan, and planning to publish the National Risk Assessment in Spring 2018 are welcome efforts. It is essential to continue improving the effectiveness of the AML/CFT framework, including through bolstering risk based supervision and licensing requirements for banks based on robust fit and proper tests. At the same time, a framework for due diligence should be developed for the new residency program to safeguard financial integrity. The authorities should continue to build cooperation across Europe and beyond, including continued negotiations with the European Union (EU) on an association agreement. Further cooperation with Italy, including establishing a memorandum of understanding with the Bank of Italy, will help strengthen institutional capacity of San Marino.

**28. Data provision needs to be strengthened.** Easy access to timely economic data enhances transparency and is essential for investors, businesses, and policy makers to make informed decisions. Priorities include compilation of balance of payments (BOP) statistics, revising historical GDP data to reflect the recent methodological change, and ensuring compliance with international standards in existing statistics. A clear timeline for key milestones is needed to ensure adequate progress in these areas. More resources should be allocated to improve data provision and presentation and expedite the compilation of basic data in priority areas.

***Authorities' Views***

**29. The authorities plan to continue to pursue the new business model built on transparency and openness, aiming at attracting foreign investment.** They emphasized that further improving the business environment is essential, and that the process will be facilitated by the ongoing reorganization of government agencies to create a Development Agency, with the task of promoting the country and attracting investments, as well as a one-stop shop for companies, aimed at reducing red tape and simplifying the fulfillment of requirements. The authorities are also working to amend the remaining preferential tax practices to meet the BEPS standards. They are committed to pursuing the path of internationalization, including continued negotiations with the EU on the association agreement. The authorities acknowledged the importance of improving data provision and harmonization and will continue to carry out the recently initiated compilation of the BOP statistics.

# STAFF APPRAISAL

**30. The economy rebounded in 2016, but momentum is slowing amid increased banking sector uncertainties in 2017.** Growth in 2016 was supported by the general recovery in Europe, but decelerating employment growth suggests that the economy grew at a somewhat slower rate in 2017. Despite improved economic activity, banking sector deleveraging continues, and credit to the domestic economy declined further in 2017. Only moderate growth is expected in the near-and medium-term, in part due to lacking support from the deleveraging banking sector. Banking sector repair is needed to lay a solid foundation for higher medium-term growth. External position is also moderately weaker than fundamentals and desired policy, highlighting the need for policy adjustments.

**31. The reform agenda is demanding and requires strong commitments of all stakeholders.** Prolonged financial sector problems, built up over the past decade, have already incurred high costs for taxpayers, and permanent solutions are needed to limit further costs of banking sector repair passed onto future generations. The authorities' recent efforts to identify the problems, including completing the AQR, are welcome, and these efforts should be followed by decisive actions, guided by a coherent banking sector strategy.

**32. Maintaining financial stability and restoring banking sector soundness are key priorities.** The process ahead should include upfront loss recognition, prompt bank recapitalization, and NPL resolution. Market-based solutions should be sought for bank recapitalization, and public capital support should be limited to only viable, systemically important banks, following burden sharing. Banks should be subject to ambitious and credible plans aimed at significantly reducing NPLs over the medium-term while regulatory, tax and legal reforms are needed to facilitate NPL disposals. At the same time, central bank functions and bank oversight need to be strengthened to secure financial stability going forward, including developing crisis management capability, improving regulation and supervision, and adopting highest standards of central bank independence, governance, accountability, and transparency.

**33. CRSM needs to implement deep restructuring to return to viability.** The bank's restructuring likely requires changing its business model and reducing high operating costs, while ensuring prudent lending. Re-privatization of the bank should be a priority, and outsourcing some management functions, including to large foreign banks, should be considered to promote development of a sound business model.

**34. Public support of the banking sector needs to come with improvements in accountability and oversight.** A financial stability committee (FSC) should be established to improve coordination between the government and the central bank, especially for communication. A memorandum of understanding between the government and the central bank would help clarify responsibilities and a protocol for information exchange.

**35. A fiscal strategy is needed to ensure debt sustainability while securing resources for pro-growth, pro-employment policies.** Public intervention in the banking sector has created new debt management challenges. Anticipating rising public debt, the 2018 budget envisages fiscal adjustments, but the budget and level of public debt are highly uncertain and depend on the final costs of bank recapitalization borne by the state. The fiscal strategy should include sustained fiscal measures, including increasing tax revenues through a reform of indirect taxation and containing spending and improving its quality. In this regard, pension reform could help free resources for other priority areas, but the current proposal is complex and needs prioritization. Debt management capacity also needs to be developed while establishing access to external financing for the sovereign would help enhance the government's ability to respond to shocks.

**36. Further structural reform will help diversify the economy.** Increased labor market flexibility will help skills shortages but should be supported by a well-targeted social policy to help unemployed workers maintain their skills and continue job search. Further easing costs of doing business, including simplifying bureaucracy, will also help and should be aimed at improving efficiency while avoiding distortions and additional fiscal costs.

**37. San Marino should continue its efforts to enhance international cooperation, strengthen the AML/CFT framework and improve transparency.** It should continue to work on improving the effectiveness of the AML/CFT measures commensurate with the ML/TF risks, including by strengthening AML/CFT risk-based supervision of banks and licensing requirements. To further safeguard financial integrity, a framework for due diligence should be developed for the newly introduced residency programs. Further cooperation with Italy and continued negotiations with the EU on association agreement remain important.

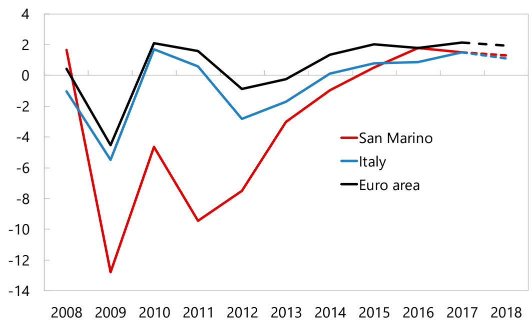
**38. Data provision remains weak and needs to be strengthened.** Easy access to economic data is fundamental to transparency and help businesses and policy makers make informed decisions. More resources and emphasis should be devoted to strengthening data provision and presentation as lack of data can pose as a major inhibition to foreign investors. The recently initiated work to compile BOP statistics is a welcome step, and progress should be also made in ensuring compliance with international standards in existing statistics.

**39. 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: Macroeconomic Developments

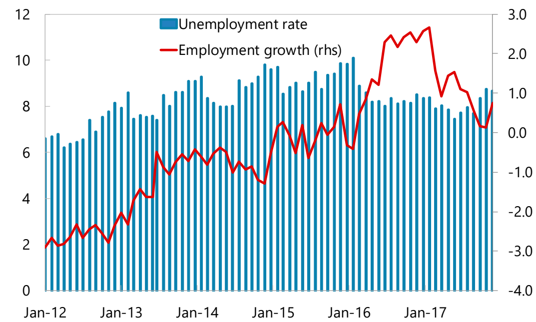
*The economy rebounded in 2016 supported by improved external environment.*

**Real GDP Growth**
(Percent)



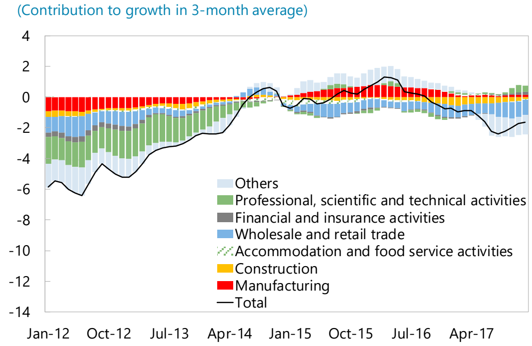

*Employment growth picked up in 2016, pushing down the unemployment rate, but the momentum slowed in 2017.*

**Labor Markets**
(percent)



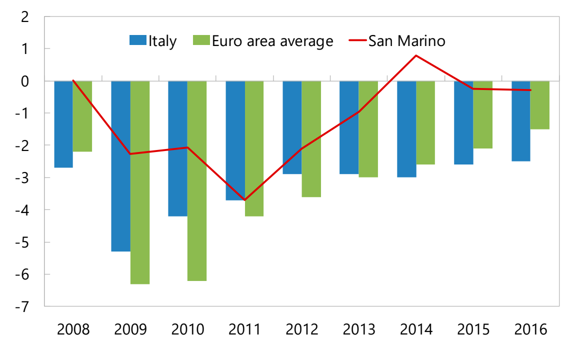

*Growth in new firms improved slightly toward the end of 2017.*

**The Number of Enterprises**
(Contribution to growth in 3-month average)



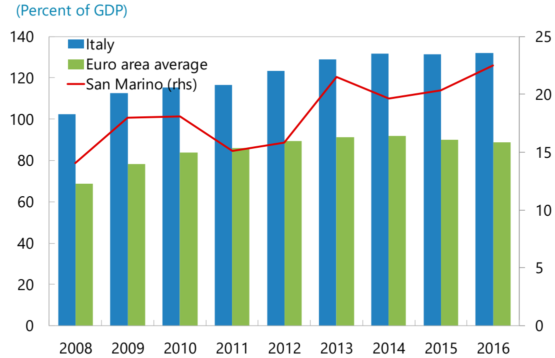

*The budget deficit was contained but slightly rose in 2016.*

**Fiscal Balance**
(Percent of GDP)



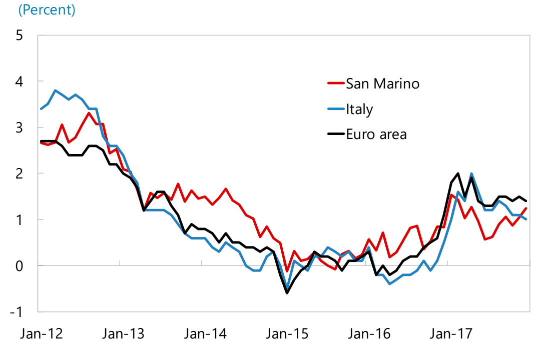

*Government debt is relatively low but expected to continue to rise.*

**Government Debt**
(Percent of GDP)




*Inflation slowed in 2017 but started to pick up recently.*

**CPI Inflation**
(Percent)

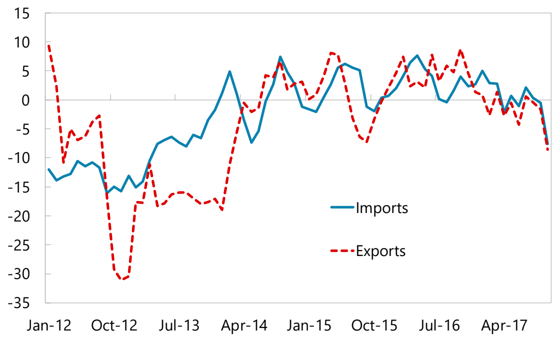



Sources: Haver, UPECEDS, World Economic Outlook, and IMF staff calculations.

## Figure 2. San Marino: High Frequency Indicators

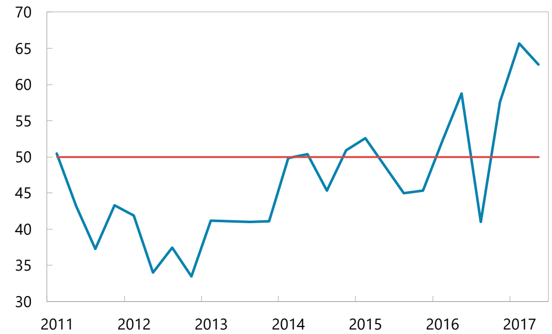
*Both exports and imports grew in 2016, but they have slowed in late 2017.*

**Imports and Exports**
(yoy growth rate in 3-month moving average)



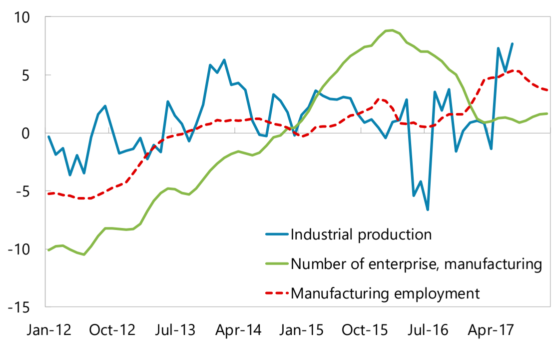

*PMI points to expansion in 2016, but there has been some correction in early 2017.*

**Purchasing Managers' Index (PMI)**
(+50; expansion)



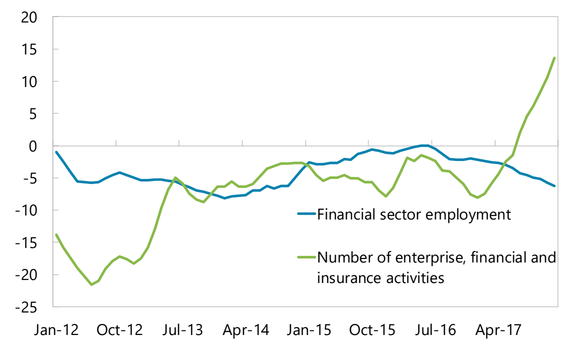

*In manufacturing, employment growth slowed somewhat at end 2017 while new firms continue to open.*

**Manufacturing**
(yoy growth rate in 3-month average)



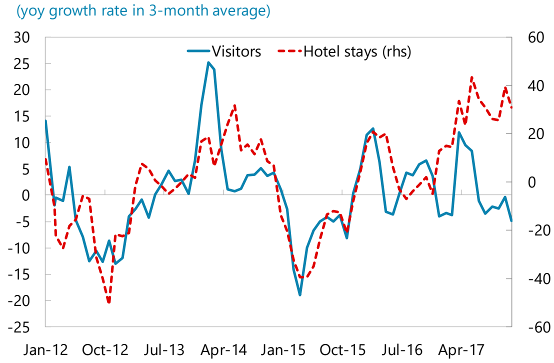

*In the banking sector, downsizing continues.*

**Financial Service**
(yoy growth rate in 3-month average)



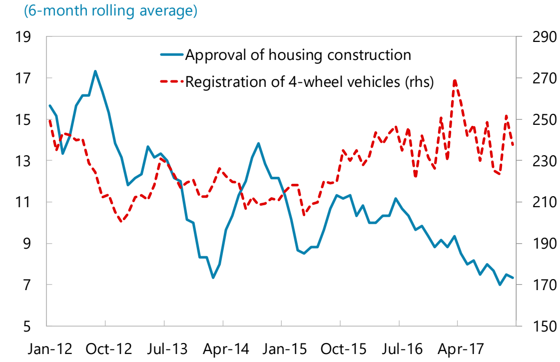

*The pattern of tourism changed in 2017 with more visitors staying overnight.*

**Tourism**
(yoy growth rate in 3-month average)




*Housing construction is slowing while car registration has stabilized.*

**Housing and Durable Consumption**
(6-month rolling average)

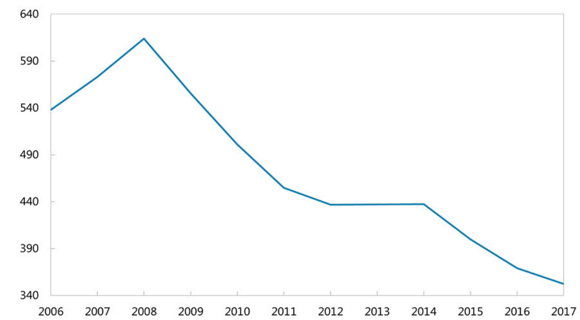



Sources: UPECEDS and IMF staff calculations.

## Figure 3. San Marino: Financial Sector Indicators

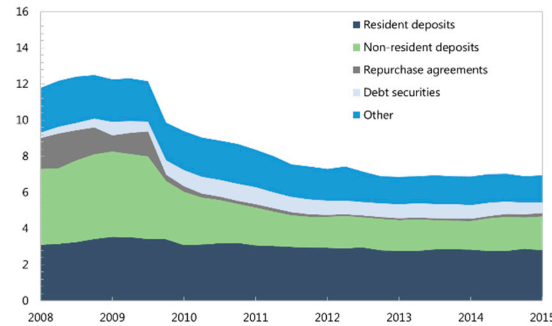
*Downsizing of the Sammarinese banking sector has continued….*

**Banking System Assets**
(Percent of GDP)



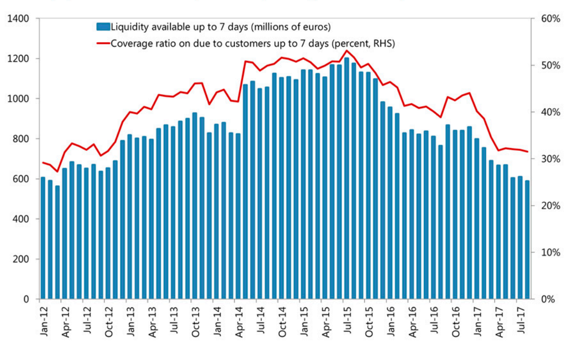
*… and it has been largely due to outflows of non-resident deposits.*

**Banking System Funding**
(Billions of euros)



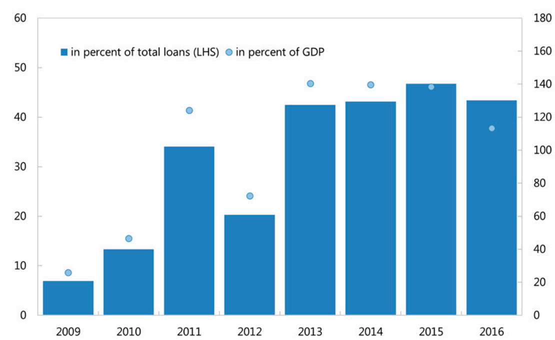

*Liquidity pressure increased in 2017 even from residents due to deepening banking sector uncertainties.*

**Bank Liquidity**
(Liquid assets as a share of liquid liabilities, excluding inter-bank loans)



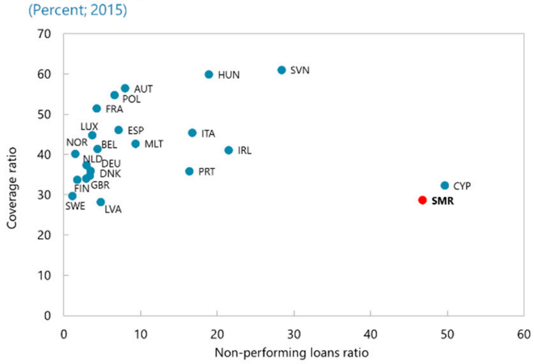

*Due to a combination of shocks, NPLs remain high…*

**Banking Sector's Non-Performing Loans**
(Percent)



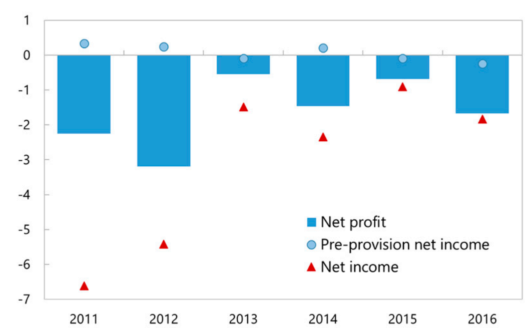

*…especially compared with other European peers.*

**Nonperforming Loans and Provisions**
(Percent; 2015)




*Banks continue to report losses, in part due to high write-offs and increased provisioning.*

**Banking Sector's Profitability**
(Percent of average total assets)




Sources: CBSM, EBA, IMF Financial Soundness Indicators, and IMF staff calculations.

## Table 1. San Marino: Selected Economic and Social Indicators, 2014–20

GDP per capita (2015): 46,185 U.S. dollars | Life expectancy at birth (2011): 83.3 years
Population (2016): 34,267 persons | Literacy, adult (2008): 96 percent

| | | | | Projection | | | |
|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
| **Activity and Prices** 1/ | | | | | | | |
| Real GDP (percent change) | -0.9 | 0.6 | 2.2 | 1.5 | 1.3 | 1.3 | 1.3 |
| Domestic demand | -4.3 | -3.6 | 4.0 | 1.1 | 4.7 | 2.8 | 1.7 |
| Final consumption | 1.0 | 1.1 | -0.7 | 0.7 | 1.2 | 1.4 | 1.4 |
| Fixed investment | -14.0 | 1.9 | 13.2 | 2.3 | 16.0 | 7.0 | 2.7 |
| Net exports | 2.5 | 3.4 | -0.7 | 0.7 | -2.2 | -0.9 | -0.1 |
| Exports | 1.1 | 2.5 | 2.1 | -0.2 | 0.1 | 0.3 | 0.2 |
| Imports | -0.6 | 0.5 | 3.0 | -0.7 | 1.8 | 1.1 | 0.2 |
| Contribution to GDP | | | | | | | |
| Domestic demand | -3.4 | -2.8 | 2.9 | 0.8 | 3.5 | 2.2 | 1.4 |
| Final consumption | 0.6 | 0.6 | -0.4 | 0.4 | 0.7 | 0.8 | 0.8 |
| Fixed investment | -2.6 | 0.3 | 2.1 | 0.4 | 2.9 | 1.4 | 0.6 |
| Net exports | 2.5 | 3.4 | -0.7 | 0.7 | -2.2 | -0.9 | -0.1 |
| Exports | 1.7 | 4.0 | 3.4 | -0.3 | 0.2 | 0.6 | 0.3 |
| Imports | 0.8 | -0.6 | -4.1 | 1.0 | -2.4 | -1.5 | -0.3 |
| Employment (percent change) | -1.6 | -0.4 | 1.0 | 1.1 | 1.1 | 1.1 | 1.1 |
| Unemployment rate (average; percent) | 8.7 | 9.2 | 8.6 | 8.0 | 7.4 | 6.8 | 6.8 |
| Inflation rate (average; percent) | 1.1 | 0.2 | 0.6 | 0.9 | 1.0 | 1.1 | 1.2 |
| Nominal GDP (millions of euros) | 1348.0 | 1373.3 | 1414.2 | 1449.0 | 1490.6 | 1529.4 | 1571.6 |
| **Public Finances** (percent of GDP) 2/ | | | | | | | |
| Revenues | 23.2 | 21.4 | 21.8 | 21.1 | 21.8 | 21.2 | 20.7 |
| Expenditure | 22.4 | 21.7 | 22.1 | 21.4 | 22.1 | 21.5 | 20.1 |
| Overall balance | 0.8 | -0.3 | -0.3 | -0.3 | -0.3 | -0.2 | 0.6 |
| Government debt | 19.6 | 20.3 | 22.5 | 56.6 | 55.5 | 54.6 | 52.8 |
| Government deposits (millions of euros) | 40.4 | 32.9 | 25.4 | 22.9 | 22.9 | 22.9 | 22.9 |
| **Money and Credit** | | | | | | | |
| Deposits (percent change) | 4.0 | ... | ... | ... | ... | ... | ... |
| Private sector credit (percent change) | 1.0 | -5.8 | -7.6 | ... | ... | ... | ... |
| Net foreign assets (percent of GDP) | 5.6 | -3.9 | ... | ... | ... | ... | ... |
| Commercial banks | -17.0 | -27.3 | ... | ... | ... | ... | ... |
| Central bank | 22.6 | 23.4 | ... | ... | ... | ... | ... |
| **External Accounts** (percent of GDP) | | | | | | | |
| Balance of goods and services | 32.6 | 32.2 | 32.8 | ... | ... | ... | ... |
| Exports | 153.5 | 152.8 | 154.4 | ... | ... | ... | ... |
| Imports | 120.8 | 120.5 | 121.7 | ... | ... | ... | ... |
| Gross international reserves (millions of U.S. dollars) | 392.0 | 367.2 | ... | ... | ... | ... | ... |
| **Exchange Rate** (average) | | | | | | | |
| Euros per U.S. dollar | 0.75 | 0.90 | 0.90 | 0.89 | 0.82 | 0.82 | 0.82 |
| Real exchange rate vis-à-vis Italy | 100.9 | 101.0 | 101.6 | 101.4 | 101.2 | 101.0 | 102.0 |
| **Financial Soundness Indicators** (percent) 3/ | | | | | | | |
| Regulatory capital to risk-weighted assets | 11.4 | 12.7 | 13.6 | ... | ... | ... | ... |
| Bad loans to total loans | 16.1 | 18.5 | 18.7 | ... | ... | ... | ... |
| Loan loss provision to total loans | 30.3 | 28.6 | 26.6 | ... | ... | ... | ... |
| Return on equity (ROE) | -21.4 | -9.0 | -10.5 | ... | ... | ... | ... |
| Liquid assets to total assets | 32.4 | 29.8 | 29.5 | ... | ... | ... | ... |
| Liquid assets to short-term liabilities | 65.4 | 58.9 | 59.1 | ... | ... | ... | ... |

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

1/ According to preliminary revised national accounts.

2/ For the central government.

3/ For 2016, latest available.

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

| | | | | Projection | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 |
| **Real and External** 1/ | | | | | | | | | | |
| Real GDP (percent change) | -0.9 | 0.6 | 2.2 | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| **Contributions to growth** 1/ | | | | | | | | | | |
| Domestic demand | -3.4 | -2.8 | 2.9 | 0.8 | 3.5 | 2.2 | 1.4 | 1.3 | 1.3 | 1.3 |
| Final consumption | 0.6 | 0.6 | -0.4 | 0.4 | 0.7 | 0.8 | 0.8 | 0.8 | 0.8 | 0.7 |
| Fixed investment | -2.6 | 0.3 | 2.1 | 0.4 | 2.9 | 1.4 | 0.6 | 0.6 | 0.6 | 0.6 |
| Net exports (contribution to growth) | 2.5 | 3.4 | -0.7 | 0.7 | -2.2 | -0.9 | -0.1 | 0.0 | 0.0 | 0.0 |
| Exports | 1.7 | 4.0 | 3.4 | -0.3 | 0.2 | 0.6 | 0.3 | 0.3 | 0.3 | 0.3 |
| Imports | 0.8 | -0.6 | -4.1 | 1.0 | -2.4 | -1.5 | -0.3 | -0.3 | -0.2 | -0.3 |
| **Public Finances** (percent of GDP) 2/ | | | | | | | | | | |
| Revenues | 23.2 | 21.4 | 21.8 | 21.1 | 21.8 | 21.2 | 20.7 | 19.5 | 19.5 | 19.4 |
| Expenditure | 22.4 | 21.7 | 22.1 | 21.4 | 22.1 | 21.5 | 20.1 | 20.1 | 20.1 | 20.0 |
| Overall balance | 0.8 | -0.3 | -0.3 | -0.3 | -0.3 | -0.2 | 0.6 | -0.6 | -0.6 | -0.6 |
| Primary balance | 1.0 | 0.3 | 0.0 | 0.1 | 0.6 | 0.6 | 1.4 | 0.2 | 0.2 | 0.2 |
| Government debt | 19.6 | 20.3 | 22.5 | 56.6 | 55.5 | 54.6 | 52.8 | 52.3 | 51.7 | 51.2 |

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

1/ According to preliminary revised national accounts.

2/ For the central government.

## Table 3. San Marino: Financial Soundness Indicators, 2009–17

| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 1/ |
|---|---|---|---|---|---|---|---|---|---|
| **Capital adequacy ratios** (percent) | | | | | | | | | |
| Regulatory capital to risk-weighted assets | 16.9 | 15.6 | 14.1 | 8.8 | 13.6 | 11.4 | 12.7 | 13.6 | ... |
| Capital to assets | 10.6 | 9.6 | 8.6 | 6.3 | 7.3 | 6.2 | 6.9 | 7.2 | ... |
| **Asset quality ratios** (percent) | | | | | | | | | |
| Bad loans to total loans | 2.9 | 5.9 | 7.2 | 9.6 | 13.9 | 16.1 | 18.5 | 18.7 | ... |
| Nonperforming loans to total loans | 6.9 | 11.9 | 34.1 | 20.3 | 42.4 | 43.1 | 46.8 | 44.1 | ... |
| Bad loans net of provision to capital | 7.2 | 17.6 | 28.7 | 41.3 | 47.3 | 57.3 | 74.8 | 65.2 | ... |
| Nonperforming loans net of provision to capital | 36.5 | 72.5 | 273.1 | 166.1 | 289.2 | 335.8 | 340.8 | 300.0 | ... |
| Loan loss provision to total loans 2/ | 23.9 | 27.8 | 22.6 | 42.5 | 26.7 | 30.3 | 28.6 | 26.6 | ... |
| **Earning and profitability** (percent) | | | | | | | | | |
| Return on assets (ROA) 3/ | 0.1 | -0.1 | -3.3 | -2.2 | -0.6 | -1.8 | -0.7 | -0.8 | ... |
| Return on equity (ROE) 3/ | 0.5 | -0.7 | -28.8 | -22.5 | -7.8 | -21.4 | -9.0 | -10.5 | ... |
| Interest margin to gross income | 67.5 | 56.1 | 77.1 | 58.5 | 46.1 | 32.1 | 37.3 | 38.7 | ... |
| Non-interest expenses to gross income | 34.1 | 48.3 | 66.7 | 69.7 | 81.2 | 50.7 | 60.7 | 67.3 | ... |
| Trading income to gross income | 12.8 | 1.5 | -6.3 | 11.7 | 13.3 | 13.9 | 1.9 | 7.2 | ... |
| Administrative expenses to non-interest expenditures | 51.3 | 61.9 | 69.2 | 69.7 | 66.1 | 55.6 | 57.1 | 62.7 | ... |
| **Liquidity** (percent) | | | | | | | | | |
| Liquid assets to total assets | ... | ... | ... | 28.0 | 29.6 | 32.4 | 29.8 | 29.5 | 11.2 |
| Liquid assets to short-term liabilities | ... | ... | ... | 58.7 | 60.6 | 65.4 | 58.9 | 59.1 | 31.5 |
| Loans to deposits | 76.5 | 85.0 | 76.8 | 91.8 | 86.7 | 80.0 | 81.8 | 81.1 | 78.7 |
| **Memo items** | | | | | | | | | |
| Banking system assets (millions of euros) | 9,447.2 | 8,090.9 | 6,721.2 | 6569.8 | 6141.0 | 6082.2 | 5657.4 | 5306.3 | 5238.6 |
| percent of GDP | 555.5 | 500.9 | 454.9 | 468.8 | 452.5 | 452.7 | 399.7 | 369.0 | 352.1 |

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

1/ Latest available.

2/ Based on total loan loss provision, which covers problem loans and performing loans.

3/ Before extraordinary items and taxes.

## Table 4. San Marino: Statement of Operations for Budgetary Central Government, 2012–20

(Percent of GDP)

| | | | | | | Projection | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 |
| **Revenue** | 21.6 | 20.8 | 23.2 | 21.4 | 21.8 | 21.1 | 21.8 | 21.2 | 20.7 |
| Taxes 1/ | 15.6 | 15.7 | 17.7 | 16.2 | 15.4 | 15.8 | 16.6 | 16.7 | 16.3 |
| Income Taxes | 7.5 | 7.9 | 8.3 | 8.3 | 7.7 | 7.7 | 7.6 | 7.7 | 7.6 |
| Non-income taxes | 8.1 | 7.7 | 9.4 | 7.9 | 7.7 | 8.1 | 9.0 | 9.0 | 8.7 |
| Taxes on international trade and transactions | 4.7 | 5.2 | 6.6 | 5.3 | 5.2 | 5.6 | 5.3 | 5.4 | 5.3 |
| Other taxes | 3.4 | 2.5 | 2.8 | 2.6 | 2.5 | 2.5 | 3.6 | 3.5 | 3.5 |
| Non-tax revenue | 6.0 | 5.2 | 5.4 | 5.2 | 6.4 | 5.3 | 5.2 | 4.5 | 4.4 |
| **Expenditure** | 23.7 | 21.8 | 22.4 | 21.7 | 22.1 | 21.4 | 22.1 | 21.5 | 20.1 |
| Current Expenditure | 21.4 | 20.4 | 20.2 | 20.3 | 20.0 | 20.3 | 20.0 | 19.4 | 18.8 |
| Compensation of employees | 7.3 | 7.3 | 6.8 | 6.7 | 6.6 | 6.7 | 6.4 | 6.3 | 6.1 |
| Use of goods and services | 2.2 | 2.0 | 2.2 | 2.0 | 2.0 | 2.0 | 1.7 | 1.6 | 1.5 |
| Interest | 0.1 | 0.1 | 0.2 | 0.2 | 0.3 | 0.4 | 0.8 | 0.8 | 0.8 |
| Transfers | 11.5 | 10.7 | 10.7 | 11.1 | 10.9 | 10.8 | 10.7 | 10.4 | 10.0 |
| To other general government units | 10.5 | 10.0 | 9.9 | 10.3 | 10.1 | 10.2 | 10.0 | 9.8 | 9.5 |
| Other expenses (including subsidies) | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 | 0.3 | 0.3 | 0.3 | 0.3 |
| Capital Expense | 2.3 | 1.4 | 2.2 | 1.4 | 2.1 | 1.2 | 2.1 | 2.0 | 1.3 |
| Net acquisition of non-financial assets | 6.0 | 7.2 | 2.2 | 3.6 | 0.8 | 1.8 | 0.9 | 0.9 | 0.9 |
| Asset purchase | 1.6 | 0.9 | 2.2 | 0.9 | 0.9 | 1.0 | 1.0 | 0.9 | 0.9 |
| Asset sale | -4.4 | -6.2 | 0.0 | -2.6 | 0.1 | -0.8 | 0.0 | 0.0 | 0.0 |
| Gross Operating Balance | 0.2 | 0.5 | 3.0 | 1.1 | 1.8 | 0.9 | 1.8 | 1.8 | 1.9 |
| **Net lending (+)/borrowing (-) (fiscal balance)** | -2.1 | -1.0 | 0.8 | -0.3 | -0.3 | -0.3 | -0.3 | -0.2 | 0.6 |
| **primary balance** | -2.0 | -0.9 | 1.0 | 0.0 | 0.0 | 0.1 | 0.6 | 0.6 | 1.4 |
| *Memorandum items* | | | | | | | | | |
| Social Security balance | -1.4 | -0.5 | -0.4 | -0.4 | -0.6 | ... | ... | ... | ... |
| Public debt | 15.8 | 21.5 | 19.6 | 20.3 | 22.5 | 56.6 | 55.5 | 54.6 | 52.8 |
| Public debt, ex. obligation to amortize CRSM 2016 loss | 15.8 | 21.5 | 19.6 | 20.3 | 22.5 | 22.5 | 22.5 | 22.4 | 21.4 |
| Government deposits | 5.4 | 4.1 | 3.0 | 2.4 | 1.8 | 1.6 | 1.5 | 1.5 | 1.5 |
| Nominal GDP (in millions of euros) | 1360.3 | 1361.5 | 1348.0 | 1373.3 | 1414.2 | 1449.0 | 1490.6 | 1529.4 | 1571.6 |

Sources: Sammarinese authorities; and IMF staff calculations and projections.
1/ Does not reflect the introduction of the VAT.

# Annex I. Risk Assessment Matrix[1]

| Source of Risks | Impact if Realized | Policy Response |
|---|---|---|
| High<br>**Structurally weak growth in Italy and the Euro area.** Low productivity growth, high debt, and failure to fully address crisis legacies by undertaking structural reforms amidst persistently low inflation undermine medium-term growth. | High<br>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 fully operate.<br>• Postpone fiscal adjustment; reevaluate periodically. |
| High<br>**Tighter global financial conditions:** Against the backdrop of continued monetary policy normalization and increasingly stretched valuations across asset classes, an abrupt change in global risk appetite could lead to sudden, sharp increases in interest rates and associated tightening of financial conditions. | Medium<br>Tighter global financial conditions could result in possibly higher costs of borrowing in the short-term if the sovereign seek external financing. | • Carefully assess alternative options in seeking external financing. |
| High<br>**Rapid increase in fiscal costs related to banking sector repair, including further need for bank recapitalization.** | High<br>Fiscal costs of banking sector clean-up could rise fast, leading to much higher government debt, undermining fiscal sustainability. | • Banking sector strategy needs to be time-bound.<br>• Capital shortfalls should be met primarily by the market to minimize the cost to the public. |
| Medium<br>**Failure to clean up bank balance sheets, leading to a loss of confidence in the system.** | High<br>A loss of confidence in the system would likely lead to large public recapitalization needs and would have significant growth and fiscal implications. | |
| Medium<br>**Significant delay in implementing indirect tax reform.** | High<br>Continued low levels of revenue will inhibit rebuilding fiscal buffers and implementing pro-growth policies. | • Expedite preparing reform proposals.<br>• Seek technical support as needed. |
| Medium<br>**Higher medium-term growth from inclusion in Italy's tax whitelist.** | Medium<br>The industrial and service sectors could bounce back, boosting growth, tax revenue, and banks' margins. | • Stick to reform plans despite upside. |

[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.

| Source of Risks | Impact if Realized | Policy Response |
|---|---|---|
| **Low**<br>**Loss of cross-border or domestic electronic payment services:** significantly curtails domestic and cross-border payments. | **Medium**<br>Disruption of retail and wholesale electronic payment services leads to an abrupt adjustment in consumption and trade. A sudden shift to cash may cause short-term currency shortages. | • A domestic electronic payment services provider has been licensed to put in place the required infrastructure, and the authorities continue to work on mitigating the risk. |
| **Low**<br>**Tensions with neighboring Italy resurface.** | **High**<br>Persistent tensions would dissuade Italian corporates and banks from doing business with San Marino, thus affecting growth. | • Enhance focus on international relations.<br>• Start the credit register on schedule.<br>• Continue to work towards early adoption of OECD initiative for exchange of tax information. |

# Annex II. Debt Sustainability Analysis

*The debt-to-GDP ratio is projected to rise to 57 percent in 2017, reflecting fiscal costs of banking sector intervention. The debt ratio is expected to edge down over time, but slower growth and/or a contingent liability shock could push the debt-to-GDP ratio above 70 percent. San Marino faces an unprecedented level of public debt, and needs fiscal adjustments to ensure debt sustainability.*

**Baseline scenario.** The economy is projected to slow somewhat in 2017 after a rebound in 2016 while real GDP growth reaching at 1.3 percent in the medium term. The overall balance is projected to improve towards 0.6 percent of GDP in 2020 before it deteriorates to -0.6 percent as temporary measures are phased out. The primary balance remains in surplus during the projection period. The government yet again intervened in the banking system in 2017, guaranteeing amortization of the state bank's €493 million loss (34 percent of GDP) over 25 years. In this central scenario, public debt is projected to jump to 57 percent of GDP in 2017, and gradually come down to around 52 percent by 2022. Gross financing needs are expected to stay low given that most debt is assumed to be structured as a bullet bond which falls due after the projection period. Moreover, existing bonds also only begin to mature after the end of the projection period.[1]

**Stress test.** Debt is particularly vulnerable to slower growth and realization of contingent liabilities:[2]

- **Real GDP growth shock.** Real GDP growth is assumed to be one standard deviation lower than the baseline scenario during 2018–19. The debt-to-GDP ratio increases to around 65 percent.

- **Real interest rate shock.** The interest rate increases with 300 basis points during 2018–22 in this scenario. If these higher interest rates do not spillover to the amortization of the CRSM loss, the projected debt-to-GDP is around 0.5 percent higher in 2022. If the higher interest rate spillover to the amortization of the CRSM loss the debt-to-GDP ratio will reach 56 percent by 2022.

- **Real exchange rate shock.** In this scenario, the real exchange rate depreciates by 13 percent in 2018. This only delivers a marginally higher debt trajectory.

- **Primary balance shock.** The primary balance is assumed to widen by an accumulated 1.7 percent of GDP during the projection period in this scenario. This would lift the project debt-to-GDP path by approximately 2 percentage points vis-à-vis the baseline scenario.

- **Contingent liability shock.** This scenario assumes that contingent liabilities of around 20 percent of GDP from the banking system materialize in 2018. This would push the debt-to-GDP ratio up to a level around 75 percent.

- **Combined shock.** The real GDP growth, contingent liability, and real interest rate shocks materialize simultaneously, the debt-to-GDP ratio jumps to around 90 percent.

[1] A bond of EUR 85 million fall due in December 2023, and two others of a total of EUR 50 million fall due in 2026.

[2] See Selected Issues Paper for more discussions on contingent liabilities and debt path under various scenarios.

## San Marino Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(in percent of GDP unless otherwise indicated)

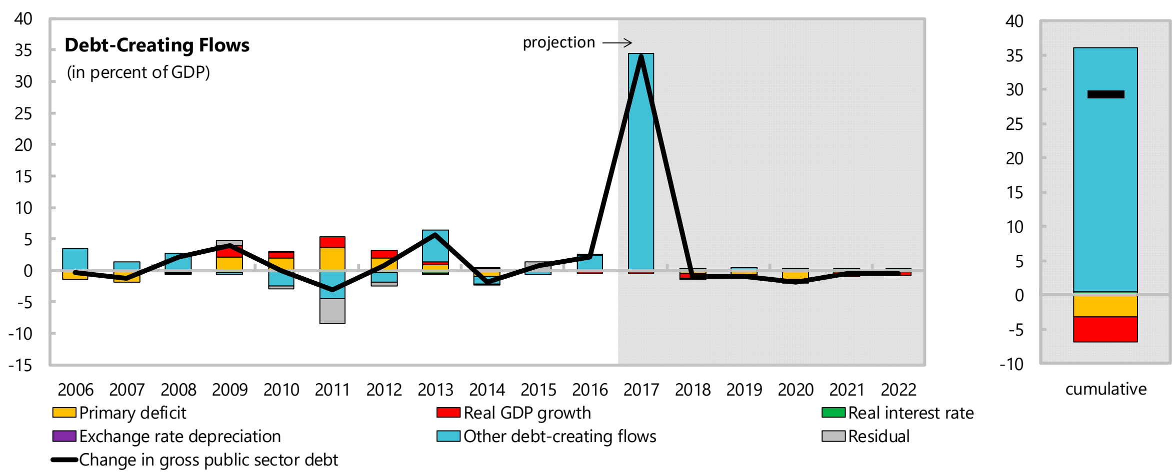
### Debt, Economic and Market Indicators [1/]

| | Actual | | | Projections | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2009-2014 [2/] | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
| Nominal gross public debt | 18.1 | 20.3 | 22.5 | 56.6 | 55.5 | 54.6 | 52.8 | 52.2 | 51.7 |
| Public gross financing needs | 5.0 | 3.2 | 4.4 | 2.1 | 2.1 | 2.0 | 1.1 | 2.3 | 2.3 |
| Real GDP growth (in percent) | -6.0 | 0.6 | 2.2 | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation (GDP deflator, in percent) | 1.6 | 1.3 | 0.8 | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Nominal GDP growth (in percent) | -4.6 | 1.9 | 3.0 | 2.5 | 2.9 | 2.6 | 2.8 | 2.7 | 2.7 |
| Effective interest rate (in percent) [4/] | 0.6 | 1.2 | 1.6 | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |

| As of February 01, 2018 | | |
|---|---|---|
| Sovereign Spreads | | |
| EMBIG (bp) 3/ | | n.a. |
| 5Y CDS (bp) | | n.a. |
| Ratings | Foreign | Local |
| Moody's | n.a. | n.a. |
| S&Ps | n.a. | n.a. |
| Fitch | BBB- | BBB- |

### Contribution to Changes in Public Debt

| | Actual | | | Projections | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2006-2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | cumulative | debt-stabilizing primary balance [9/] |
| Change in gross public sector debt | 0.9 | 0.7 | 2.2 | 34.1 | -1.0 | -0.9 | -1.8 | -0.5 | -0.5 | 29.2 | -0.3 |
| Identified debt-creating flows | 1.7 | -0.7 | 2.0 | 34.1 | -1.0 | -0.9 | -1.8 | -0.5 | -0.5 | 29.2 | |
| Primary deficit | 1.6 | 0.0 | 0.0 | -0.1 | -0.6 | -0.6 | -1.4 | -0.2 | -0.2 | -3.1 | |
| Primary (noninterest) revenue and grants | 20.9 | 21.4 | 21.8 | 21.1 | 21.8 | 21.2 | 20.7 | 19.5 | 19.5 | 123.8 | |
| Primary (noninterest) expenditure | 22.5 | 21.4 | 21.8 | 21.0 | 21.2 | 20.6 | 19.3 | 19.3 | 19.2 | 120.7 | |
| Automatic debt dynamics [5/] | 0.9 | -0.1 | -0.3 | -0.2 | -0.7 | -0.6 | -0.6 | -0.6 | -0.6 | -3.3 | |
| Interest rate/growth differential [6/] | 0.9 | -0.1 | -0.3 | -0.2 | -0.7 | -0.6 | -0.6 | -0.6 | -0.6 | -3.3 | |
| Of which: real interest rate | -0.1 | 0.0 | 0.2 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.4 | |
| Of which: real GDP growth | 1.0 | -0.1 | -0.4 | -0.3 | -0.7 | -0.7 | -0.7 | -0.7 | -0.7 | -3.7 | |
| Exchange rate depreciation [7/] | 0.0 | 0.0 | 0.0 | … | … | … | … | … | … | … | |
| Other identified debt-creating flows | -0.8 | -0.5 | 2.3 | 34.4 | 0.3 | 0.2 | 0.2 | 0.3 | 0.2 | 35.6 | |
| Drawdown of deposits and other opera | -2.6 | -0.5 | -0.5 | 0.4 | 0.3 | 0.2 | 0.2 | 0.3 | 0.2 | 1.6 | |
| Contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| Investment in CRSM | 1.8 | 0.0 | 2.8 | 34.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 34.0 | |
| Residual, including asset changes [8/] | -0.8 | 1.4 | 0.2 | 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).

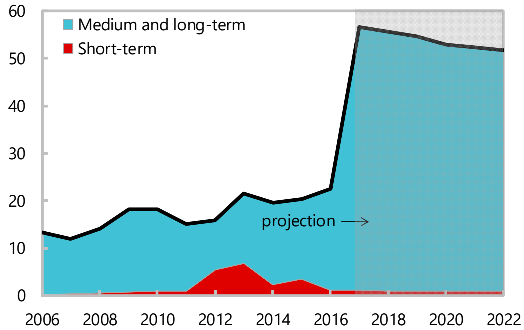
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

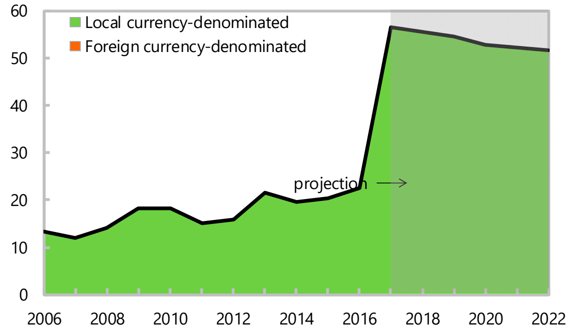
## San Marino Public DSA—Composition of Public Debt and Alternative Scenarios

### Composition of Public Debt

**By Maturity**
(in percent of GDP)



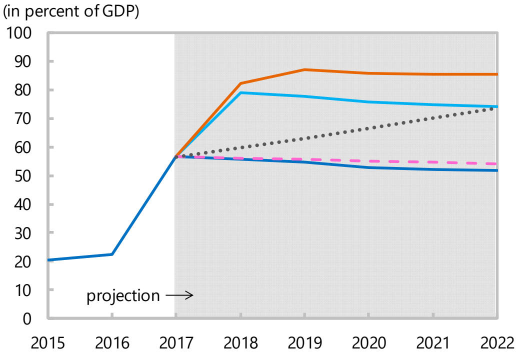

**By Currency**
(in percent of GDP)



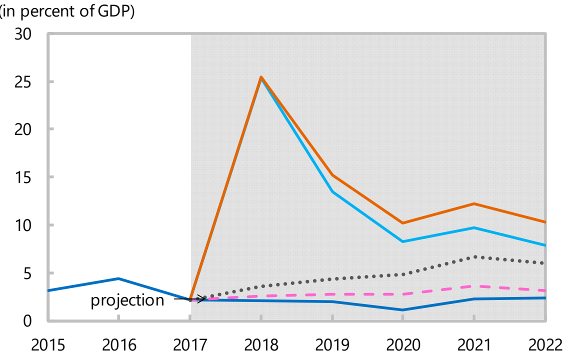

### Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance
Combined rate, growth, and liability

**Gross Nominal Public Debt**
(in percent of GDP)




**Public Gross Financing Needs**
(in percent of GDP)



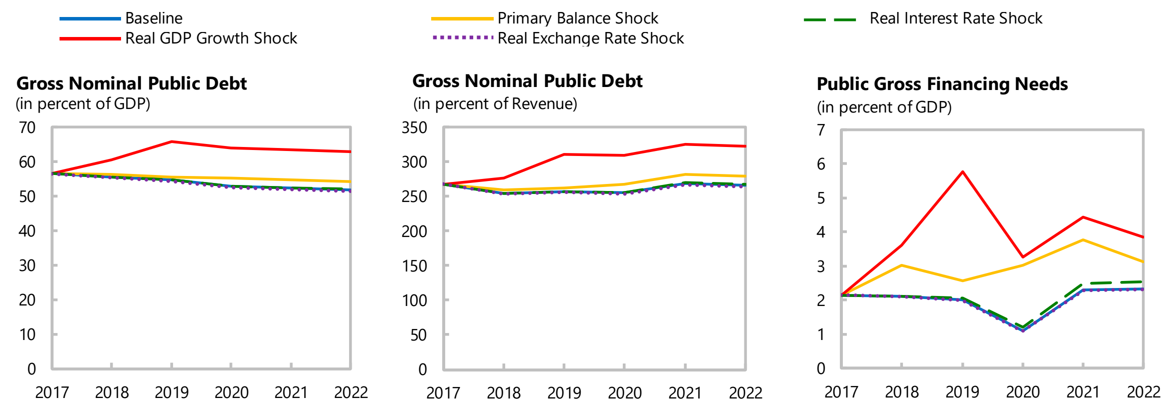

### Underlying Assumptions
(in percent)

| Baseline Scenario | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary Balance | 0.1 | 0.6 | 0.6 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |
| **Constant Primary Balance Scenario** | | | | | | |
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary Balance | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 | 0.1 |
| Effective interest rate | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |

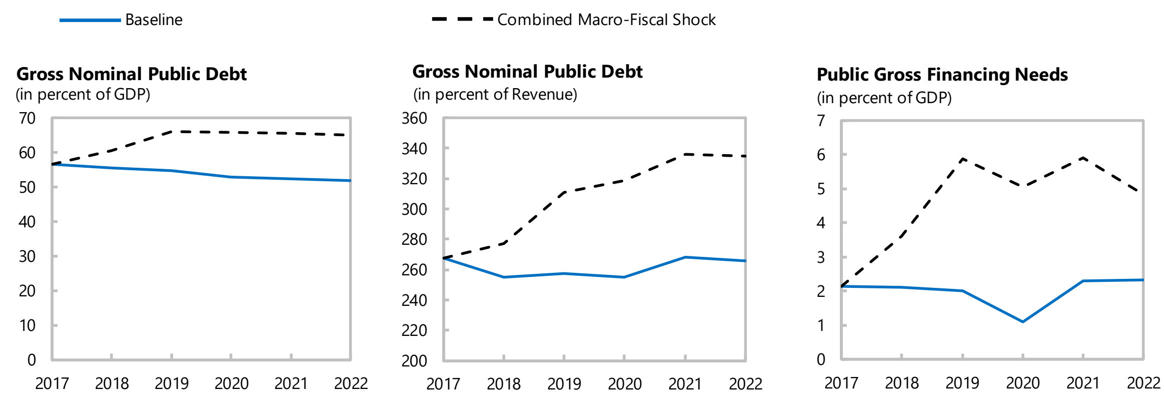
| Historical Scenario | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| Real GDP growth | 1.5 | -3.5 | -3.5 | -3.5 | -3.5 | -3.5 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary Balance | 0.1 | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 |
| Effective interest rate | 1.4 | 1.5 | 1.5 | 1.5 | 1.5 | 1.5 |
| **Contingent Liability Shock** | | | | | | |
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary Balance | 0.1 | -22.6 | 0.6 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.6 | 1.6 | 1.7 | 1.6 | 1.7 |
| **Combined rate, growth, and liability** | | | | | | |
| Real GDP growth | 1.5 | -3.6 | -3.6 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 0.3 | 0.1 | 1.4 | 1.4 | 1.4 |
| Primary Balance | 0.1 | -22.6 | 0.6 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 2.3 | 2.6 | 2.5 | 2.7 |

## San Marino Public DSA—Stress Tests

### Macro-Fiscal Stress Tests




### Additional Stress Tests




### Underlying Assumptions

(in percent)

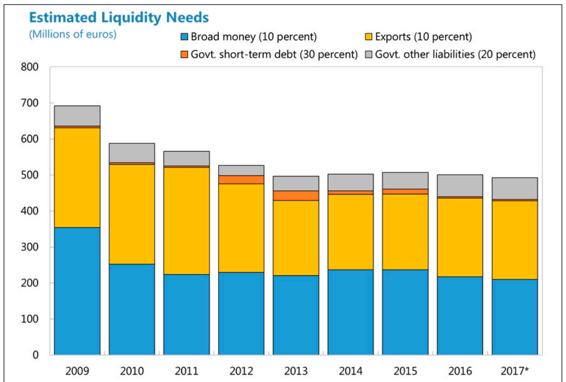
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| **Primary Balance Shock** | | | | | | |
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary balance | 0.1 | -0.3 | 0.5 | -0.2 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |
| **Real Interest Rate Shock** | | | | | | |
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 1.6 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary balance | 0.1 | 0.6 | 0.6 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.7 | 1.7 | 1.7 | 1.9 |
| **Combined Shock** | | | | | | |
| Real GDP growth | 1.5 | -3.6 | -3.6 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 0.3 | 0.1 | 1.4 | 1.4 | 1.4 |
| Primary balance | 0.1 | -0.8 | -2.1 | -0.2 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.7 | 1.9 | 1.9 | 2.1 |

| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| **Real GDP Growth Shock** | | | | | | |
| Real GDP growth | 1.5 | -3.6 | -3.6 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 0.3 | 0.1 | 1.4 | 1.4 | 1.4 |
| Primary balance | 0.1 | -0.8 | -2.1 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.6 | 1.7 | 1.6 | 1.7 |
| **Real Exchange Rate Shock** | | | | | | |
| Real GDP growth | 1.5 | 1.3 | 1.3 | 1.3 | 1.3 | 1.3 |
| Inflation | 0.9 | 2.0 | 1.3 | 1.4 | 1.4 | 1.4 |
| Primary balance | 0.1 | 0.6 | 0.6 | 1.4 | 0.2 | 0.2 |
| Effective interest rate | 1.4 | 1.5 | 1.6 | 1.6 | 1.6 | 1.6 |

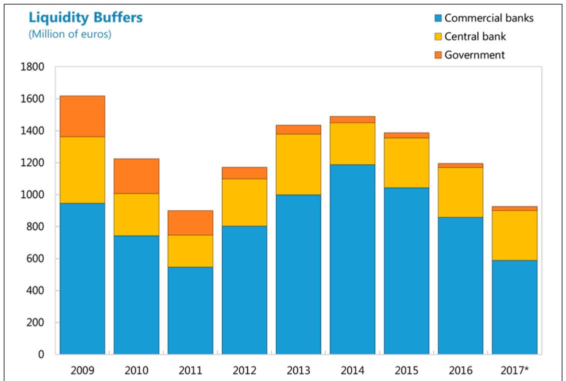
Source: IMF staff.

# Annex III. Reserve Adequacy Assessment

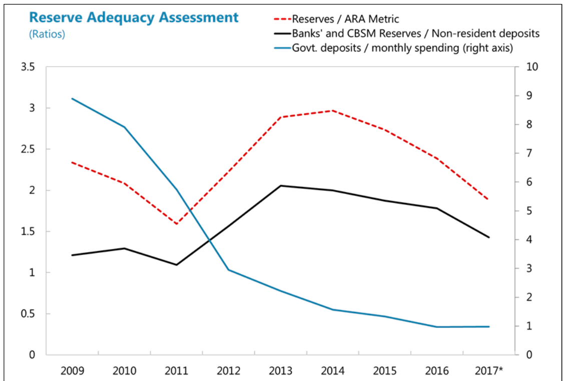
*San Marino is an open economy that adopted euro as legal tender but has no access to the lender of last resort (LOLR) and the external market. This calls for maintaining high reserve buffers. Despite recent deterioration, the overall level of reserves seems adequate. Nevertheless, establishing an access to Eurosystem LOLR facilities should be explored and fiscal buffers should be enhanced.*



Sources: CBSM; Ministry of Finance; and IMF staff. * Preliminary data.



Sources: CBSM; Ministry of Finance; and IMF staff. * Preliminary data.



Sources: CBSM; Ministry of Finance; and IMF staff. * Preliminary data.

**Liquidity needs** include buffers for loss of export income, short-term deposits withdrawals, and government roll-over needs. According to established weights for countries without market access, the current level of possible liquidity drains is close to €500 million, largely from bank deposits and export revenues.[1]

**Available reserves** are composed of decentralized liquidity buffers by commercial banks, and centralized resources, namely, government deposits and liquid assets of the Central Bank of San Marino. The decentralized liquidity buffers represent the largest share of reserves. These have been declining in recent years and a further deterioration may lead to liquidity pressures. Developing an institutional arrangement for LOLR is advisable, as is exploring the access to Eurosystem liquidity facilities for Sammarinese banks.[2]

**Reserve adequacy measures have been declining but are still above appropriate benchmarks**. The ratio of liquidity buffers to estimated liquidity needs has declined to 1.9, but remains above the 1–1.5 range, generally judged as adequate. Also, the coverage of commercial banks liquidity buffers of non-resident deposits is well above 100 percent. However, government deposits barely cover one month of spending. It would be appropriate to start rebuilding fiscal buffers during the ongoing economic recovery.

[1] Guidance Note on the Assessment of Reserve Adequacy and Related Considerations, IMF (2016).

[2] Currently, there is no legal basis for direct access to Eurosystem liquidity facilities.

# Annex IV. Authorities' Response to Past IMF Recommendations

| Fund Policy Advice from 2017 Consultation | Authorities' Action |
|---|---|
| **Financial Sector Policy:**<br>• Complete AQR and repair banks' balance sheets.<br>• Managing NPLs.<br>• Remove remaining obstacles to NPL resolution.<br>• Restructure CRSM.<br>• Revamp bank supervision and develop a macroprudential policy framework. | • The 2016 AQR became outdated due to delays caused by high turnover of central bank management. The central bank has recently initiated an update of the AQR to complete the diagnostic in coming months.<br>• Management of the CRSM has been changed multiple times in 2017, but restructuring of CRSM is still pending. A new business plan based on realistic assumptions is yet to be prepared.<br>• Bank Decree Law was issued to allow banks to spread their losses over up to 30 years,<br>• No burden sharing took place in dealing with the loss reported by CRSM and the merger of Asset Banca into CRSM.<br>• Domestic credit registry was launched in 2017.<br>• Real estate market was partially liberalized to non-residents.<br>• The authorities plan to reform the central bank structure and operations. |
| **Fiscal Policy:**<br>• Start a gradual fiscal adjustment to rebuild buffers including:<br>1) Introducing a Value Added Tax (VAT) to increase tax revenue.<br>2) Improving spending quality and relocating spending to more growth-friendly expenditure categories.<br>3) Lowering current spending by a modest cut in wage bill and some rationalization of health care spending.<br>• Advance pension reform.<br>• Establishing access to external financing. | • The 2018 budget envisages fiscal adjustment measures, including extraordinary tax measures and some current spending cuts, but uncertainty remains in the fiscal account until the AQR update clarifies the final cost of banking sector repair.<br>• Increased capital spending is envisaged in 2018 and 2019.<br>• New pension reform proposals have been presented, but it contains 30 potential measures with multiple objectives.<br>• The VAT was not introduced yet, but external experts were appointed to work on the VAT proposal. The government aims to discuss the draft legislation by mid-2018 with a transitional phase in 2019 and full implementation by 2020. |
| **Structural Reforms:**<br>• Improve the business environment and increase labor market flexibility.<br>• Enhance vocational training to improve productivity.<br>• Continue to engage in international cooperation and improve transparency.<br>• Strengthen data provision. | • "Development Law" adopted in 2017 includes easing the hiring process of nonresidents in all sectors.<br>• Initiatives are underway to improve the business environment, including creating the Agency for Development to promote and attract foreign investment, and the one-stop-shop for companies to have more efficient administration in establishing a business.<br>• The AML/CFT regulatory framework has been recently updated aimed at meeting international standards.<br>• Negotiations with EU on the association agreement continues.<br>• Data provision remains weak, and producing BOP statistics is long overdue. However, the State Congress appointed an intersectoral working group tasked with compiling BOP statistics in January 2018. |

INTERNATIONAL MONETARY FUND

# REPUBLIC OF SAN MARINO

March 6, 2018

## STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

| Prepared By | European Department |
| --- | --- |

## CONTENTS

# FUND RELATIONS

(As of January 17, 2018)

**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

**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] The current classifications of San Marino's de jure and de facto exchange rate arrangements are "no separate legal tender".

[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 the EU, including the Monetary Agreement.

**Latest Article IV Consultation:**

San Marino is on a 12-month cycle. The previous Article IV consultation discussions took place during January 30–February 10, 2017, and the consultation was concluded on April 3, 2017 (IMF Country Report No. 17/86).

**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

# STATISTICAL ISSUES

(As of January 17, 2018)

| Assessment of Data Adequacy for Surveillance |
|---|
| **General:** Data provision is broadly adequate for surveillance, but 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 appointed two national GDDS coordinators and announced their objective to increase the frequency of website updates in order to improve data dissemination. Since March 2012, national and fiscal accounts, as well as monetary and financial sector data are compiled according to international standards, but some key statistics (in real and fiscal sectors) are available only with delays and, in many cases, are at a lower-than-standard frequency and level of detail. The balance of payments statistics are not yet available. |
| **National Accounts:** National accounts data for 1995 onward have been calculated in accordance with ESA95, and data are compiled annually based on all three approaches—income, production, and expenditure, albeit with about 10-months delay. Methodological improvements starting 2015 lead to historical series revision. Employment data are available monthly. An industrial production index based on electricity consumption, launched in 2000, became available monthly in 2009. Consumption and business sentiment indices have been compiled starting in 2007 based on annual household and business surveys. |
| **Price Statistics:** Consumer prices data are available monthly. |
| **Government Finance Statistics:** The authorities have provided data for the central government, state-owned enterprises, and social security fund for 2004–16, preliminary data for 2017 and the budget for 2018. However, some of the data have not been compiled in accordance with IMF standards. Financing items, such as amortization, are included as expenditures while "financing needs" are included among revenues. The authorities report annually fiscal data in the GFS Yearbook, revenues, expenses and stock of assets and liabilities for the General Government in the format of the GFSM2014, the last year reported is 2016. |
| **Monetary and Financial Statistics:** The Central Bank of San Marino has made significant progress in the collection and compilation of monetary and financial statistics (MFS) and is nearly ready to introduce the Standardized Report Forms (SRFs) for the central bank and other depository corporations. Preliminary SRF-based data have been provided to STA from 2015:Q2 through August 2017 which are broadly in line with the IMF's *Monetary and Financial Statistics Manual (MFSM)*. However, these data have not yet been published pending clearance from the authorities. The authorities are expected to complete the migration to the SRFs and begin disseminating these data *in International Financial Statistics (IFS)* and national publications by October 2018. Data for Other Financial Corporations are not available. |

| Assessment of Data Adequacy for Surveillance (Concluded) |
|---|
| **Financial Sector Surveillance:** The authorities regularly report financial soundness indicators (FSIs). Eleven out of twelve core and five out of thirteen encouraged FSIs for deposit takers are disseminated on a quarterly basis. FSIs for other financial corporations, nonfinancial corporations, and households are not reported. Data are often reported with long lags. Going forward, the authorities should shift to a timelier provision of quarterly FSI data to the Fund with a time lag of no more than 4 months. |
| **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. In January 2018, the State Congress appointed an intersectoral working group tasked with compiling BOP statistics, with monthly reporting on progress. Data is expected to become available by the end of 2018. |

**San Marino: Table of Common Indicators Required for Surveillance**
(As of February 20, 2018)

| | Date of latest observation | Date received | Frequency of Data[7] | Frequency of Reporting[7] | Frequency of Publication[7] |
|---|---|---|---|---|---|
| Exchange Rates | Jan 2018 | Jan 2018 | D | D | D |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | Q3:2017 | Jan 2018 | Q | Q | Q |
| Reserve/Base Money | Q4:2016 | Dec 2017 | Q | Q | Q |
| Broad Money | Q4:2016 | Dec 2017 | Q | Q | Q |
| Central Bank Balance Sheet | Q4:2016 | Dec 2017 | Q | Q | Q |
| Consolidated Balance Sheet of the Banking System | Q3:2017 | Jan 2018 | Q | Q | Q |
| Interest Rates[2] | Q3:2017 | Jan 2018 | Q | Q | Q |
| Consumer Price Index | Dec 2017 | Feb 2018 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4] | Q4:2016 | Dec 2017 | A | A | A |
| Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government | Q4:2016 | Dec 2017 | A | A | A |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | Q4:2016 | Dec 2017 | A | A | A |
| External Current Account Balance | NA [6] | | | | |
| Exports and Imports of Goods and Services | Oct 2017 | Dec 2017 | M | M | M |
| GDP/GNP | 2016 | Dec 2017 | A | A | A |
| Gross External Debt | NA [8] | | | | |
| International Investment Position [6] | NA [8] | | | | |

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.p
[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] Including currency and maturity composition.
[6] Includes external gross financial asset and liability positions vis-à-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Lack of capacity precludes the compilation of balance of payments data at present. Fund technical assistance in this area is ongoing.

**Statement by Alessandro Leipold, Executive Director for the Republic of San Marino, and Francesco Spadafora, Senior Advisor to the Executive Director**
**March 22, 2018**

The authorities of the Republic of San Marino reiterate their appreciation for the open and cooperative discussions held with Fund staff during the Article IV consultation and for their valued recommendations and tailored advice. The authorities broadly concur with staff's analysis and will continue to rely on the Fund's recommendations to advance the diversification of the country's economic system.

After a long and severe recession that led to a cumulative loss of over a third of GDP over 2008–2014, the recovery continues and economic growth for 2018 is projected at around 1.3 percent, only slightly below its 2017 pace. After peaking at 10 percent in early 2016, the unemployment rate decreased to around 8 percent by the end of 2017; the trade surplus remains high (at 32 percent of GDP).

Uncertainties surrounding a full resolution of problems in the banking sector continue to weigh on economic performance. The authorities largely share the staff's forecast of moderate growth in the near and medium term and related risks. But they are confident that the realization of significant investment projects, notably the construction of a luxury shopping mall, constitutes an appreciable upside risk to growth.

Breaking with past practices, the authorities remain committed to strengthening and diversifying the economy while resolutely tackling long-standing issues that undermine a full recovery of the banking system's soundness and its ability to adequately finance the economy.

The authorities are finalizing a National Stability Plan (NSP) not only to address in a timely, comprehensive and coherent manner the immediate challenges facing the country but also to define a long-term vision for San Marino. Central components of the NSP are a Financial Sector Strategy to ensure a sustainable business model for the financial sector and its longer-term viability and development, as well as a Financial Stability Plan to stabilize the banking system and close its expected capital shortfall. Moreover, the NSP includes several structural reforms to make San Marino a place where ease of doing business, innovation, and quality of services are at world-class level.

To pursue the internalization path, the authorities are engaged in negotiating an Association Agreement with the European Union with a view to providing San Marino with greater integration in the Single Market. Draft laws transposing about 1,000 EU acts have been already adopted by the government and are waiting to be discussed and approved by parliament; eight negotiating sessions are scheduled for 2018 (compared to six in 2017). The association agreement will help attract foreign investments, increase competitiveness for domestic firms and banks, and diversify risks.

***Financial Sector***

The authorities are fully aware of the need to overcome the problems affecting the banking system in a timely and resolute manner, and are working to develop a comprehensive Financial Sector Strategy as recommended by staff.

In 2017 the authorities were faced with new challenging developments in the banking system. In April the government appointed a new management for Cassa di Risparmio della Repubblica di San Marino (CRSM), the country's largest bank. Following an internal audit, the new management reported a loss of €534 million (37 percent of GDP) for the 2016 financial year. In May 2017 Asset Banca, a small bank, was intervened by the Central Bank of San Marino (CBSM).

The authorities' response aimed at facilitating emergency liquidity provision by the CBSM, merging (in November 2017) Asset Banca into CRSM and recapitalizing the latter. More specifically, the government issued Bank Decree-Law 101, which allows banks to spread losses over 30 years, and committed to guaranteeing all liabilities of CRSM except equity and to recapitalizing the bank with public money. Taking advantage of this decree, CRSM booked a loss of €54 million in 2016, reducing immediate recapitalization needs, with the remaining loss to be amortized by the State over 25 years.

This response contributed to stabilize the liquidity position of the banking system, whose overall level of reserves is judged to be adequate.

In the context of finding permanent solutions to the problems afflicting the banking system, the authorities are currently reassessing some elements of this emergency response to fend off immediate risks to the stability of the system. The authorities are reviewing the modalities of addressing CRSM's losses and note that the government's commitment to absorb the remaining part of the CRSM's 2016 loss is currently not reflected in the fiscal accounts since the modalities of the operation have not yet been finalized.

The authorities fully concur with the staff's assessment that a coherent strategy for the banking sector with permanent solutions is urgently needed to safeguard financial stability and ensure the banking system's viability while minimizing costs to tax payers.

Unexpected turnover of the management of the CBSM has delayed the completion of the Asset Quality Review (AQR) launched in October 2016. A new Director General has been appointed in December 2017 and a search for a new President is underway. The authorities are currently in the process of completing the AQR update, which has been extended to cover data through mid-2017 and will provide a necessary basis for identifying the capital shortfall, recapitalizing and restructuring the banking system.

Having become the main shareholder of CRSM, the government is aware of the need to recognize losses, recapitalize and restructure it to return the bank to profitability.

Recent important steps are testament to the authorities' commitment. A Financial Stability Committee (FSC) is being established, composed of representatives of the government and the CBSM. The FSC will develop a Financial Sector Strategy (part of the broader National Stability Plan) to tackle current overall stability challenges of the banking industry and ensure its long-term sustainability. The Strategy will include a Financial Stability Plan that should foresee options to cover the banks' capital shortfall and support a system-wide NPLs cleanup. The Financial Stability Plan should also envisage reforms of the BCSM to enhance banking supervision and the setting up of a State Treasury Department to scale up debt management capacity, along with complementary reforms in the fiscal area. A domestic credit registry has been set up recently, following up on past staff's recommendations.

***Fiscal Policy***

While in recent years public finances have been managed to limit the deficit, the authorities agree with staff on the need to continue fiscal adjustment to restore financial buffers and ensure long-term sustainability, while supporting growth via public investment. Adjustment measures and structural reforms in the fiscal area are also meant to free up public resources to support the Financial Sector Strategy.

Measures center on three pillars: a spending review to reduce public spending; an overhaul of the pension system; and a reform of indirect taxation.

The 2018 budget envisages a balanced budget through corrective measures while allocating resources for spending to support job and growth. In August 2017, legislation was passed committing the government to reducing current expenditure by 10 percent in three years (2.5 percent in 2018, of which 0.65 percent already budgeted and the remaining measures to be identified before autumn).

The overhaul of the pension system aims at improving medium-term sustainability and reducing State financing while promoting a multi-pillar social security model. The general guidelines of the reform developed by a technical commission have been approved and consultations are underway with the social partners and other stakeholders. A draft reform bill is set to be presented during this year with entry into force currently envisaged for early 2019.

The reform of the system of indirect taxation, namely via the introduction of a VAT, is seen as a key step to align San Marino to international standards and increase its attraction at the international level. A VAT will enlarge the tax base and facilitate import/export operations while also improving statistical data on the economy. Preparatory analyses by an expert group are being finalized and a Law to introduce VAT is currently planned to be approved by end-2018, envisaging a transitional period in 2019 and entry into force in January 2020.

In addition to the reform of indirect taxation, a reform of direct taxation is also being planned, with a restructuring of tax incentives—whose high number makes them unclear and thus ineffective—along with an already budgeted one-off wealth tax and the improvement of the tax audit system to ensure greater fairness and effectiveness of taxation.

***Structural Reforms***

The authorities plan to continue to pursue the new business model built on transparency and openness. In their commitment to internationalize and diversify the economy, they are aware of the importance of advancing the structural reform agenda to improve the business environment and become an international innovation center and a touristic landmark; priority is being given to easing of doing business and increasing the quality of services to attract foreign investment.

In line with past Fund recommendations, recent measures target a gradual opening of the real estate market to foster an increase in property values, thus reducing write-offs in bank balance sheets due to NPLs covenants. In 2017 a Residency-by-Investment program was introduced, as in other European countries, and the new 2017 "Development Law" has streamlined the requisites for entrepreneurs to request residence.

The 2018 Budget Law gives mandate to the government to create a Development Agency, by merging the Chamber of Commerce, to promote San Marino abroad and attract companies, elective residents, tourists, and investors.

In order to create a competitive and dynamic network of innovative stakeholders able to compete at an international level, a newly-set up San Marino Innovation Institute, the former Techno Science Park, with new governance and objectives, aims at fostering innovation by attracting start-ups and venture capital.

Several reforms are being designed to align San Marino to international standards and make it more attractive on international markets. These reforms include Public Administration, the Statistical Office, the establishment of a one-stop shop for new and existing companies (aimed at reducing red tape and simplifying the fulfillment of requirements) and changes in insolvency laws. The latter will make firms' restructuring, bankruptcy and liquidation procedures clearer, faster, and more flexible and improve NPLs work-out thanks to easier and speedier recovery.

As far as the labor market is concerned, the 2017 Development Law introduced a partial workforce liberalization to facilitate hiring of non-resident workers by San Marino's firms. Further liberalizations are under study to more effectively attract skilled labor force. An employment reform envisaging the introduction of permanent contracts with an increasing protection scheme is currently being considered and a reform of temporary work contracts is also under review.

In the area of AML/CFT, over the last years San Marino has continuously engaged with the international community to enhance transparency through a series of international agreements. Acknowledging the effective actions taken, in 2015 MONEYVAL removed the country from regular follow-up and reclassified San Marino as a bi-annual follow-up case. The authorities are also working to amend the remaining preferential tax practices to meet the BEPS standards.

The authorities acknowledge the importance of improving data provision and harmonization and will continue to carry out the recently initiated compilation of BOP statistics. They are committed to pursuing the path of internationalization, including through continued negotiations with the EU on the Association Agreement.