



REPUBLIC OF SAN MARINO

SELECTED ISSUES

April 2018

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European Department

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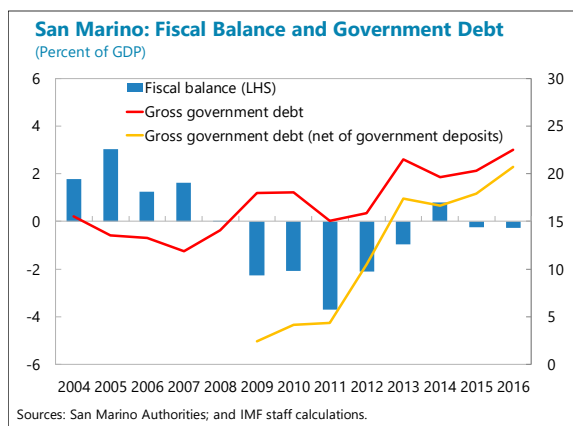
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DEBT DYNAMICS IN SAN MARINO

San Marino's history of prudent fiscal management manifested in relatively low public debt of 23 percent of GDP in 2016. Going forward, however, public debt is bound to rise, possibly substantially, due to financial sector interventions. Using IMF's debt sustainable analysis (DSA) tool, this paper presents scenarios to assess debt dynamics and discusses key considerations in developing a medium-term fiscal strategy and adjustments.

A. Background

1. San Marino has a track record of prudent fiscal management. Before 2008–09, the country ran fiscal surpluses ranging from 1 to 3 percent of GDP. These surpluses were appropriately used to build buffers in the form of government deposits and a low gross debt level (around 15 percent of GDP). At the onset of the global financial crisis, these buffers were drawn on to support the economy and the financial system, and a budget deficit emerged with a moderate increase in public debt to around 20 percent of GDP (text chart). Despite weak growth, San Marino's fiscal consolidation has been faster than in euro area economies, and the deficit has been contained in recent years.



2. San Marino's public spending and revenue relative to its GDP were smaller than those of euro area countries (Figure 1). In 2016, both revenue and expenditure were at around 20 percent of GDP, almost half of the euro area average, with wages accounting for a relatively high share of expenditures (text chart). San Marino's 2016 budget deficit was also low at 0.3 percent of GDP, much lower than the euro area average (Figure 1). However, in recent years other European microstates have tended to run larger budget surpluses (text chart).

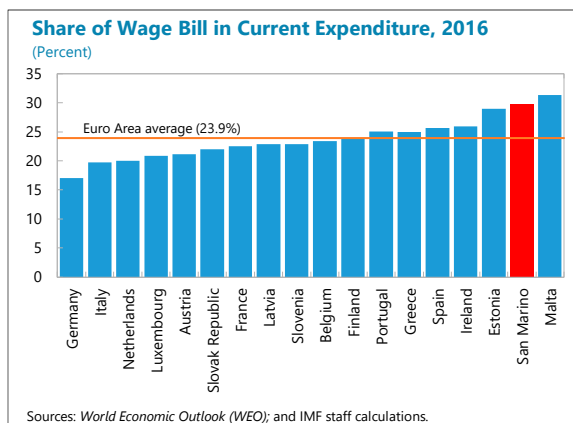
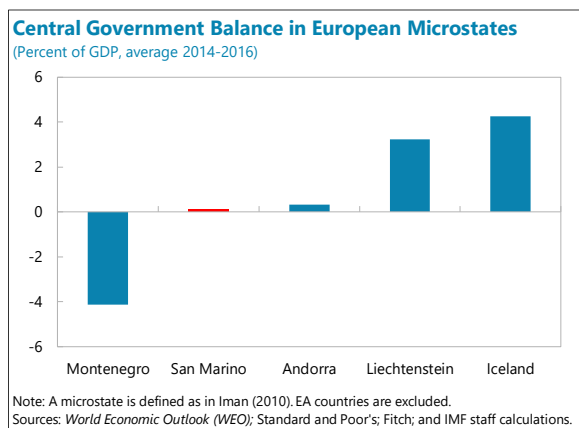
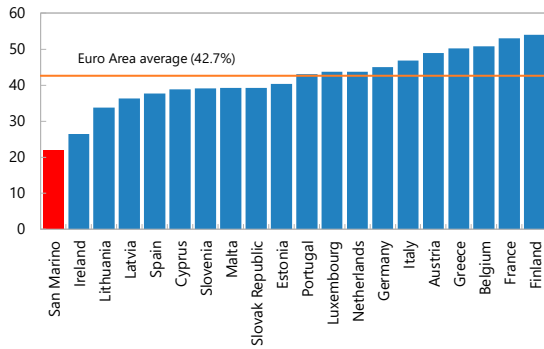


Figure 1. San Marino: Fiscal Position and Public Debt

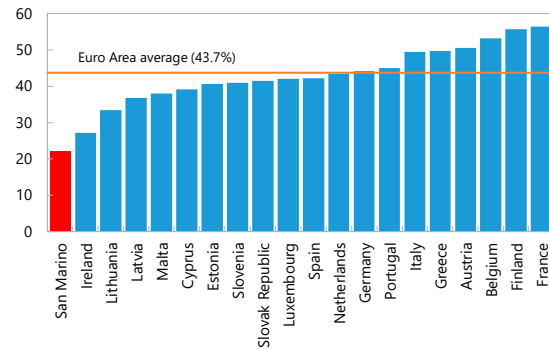
Total government revenue as a share of GDP was far below the average for euro area countries in 2016...

Government Revenues, 2016
(Percent of GDP)



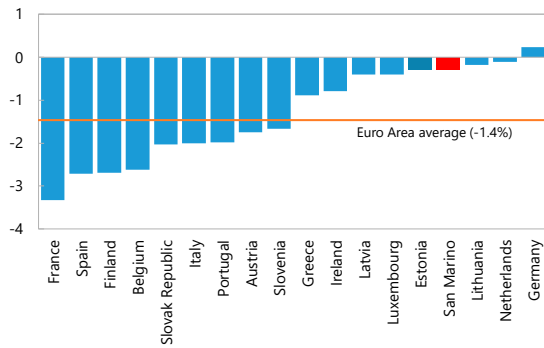
...the same holds for the total government expenditure, reflecting low revenues.

Government Expenditure, 2016
(Percent of GDP)



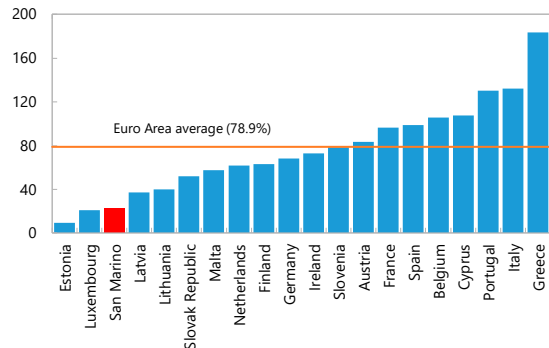
Low revenues and expenditure led to a small government deficit...

Central Government Balance, 2016
(Percent of GDP)



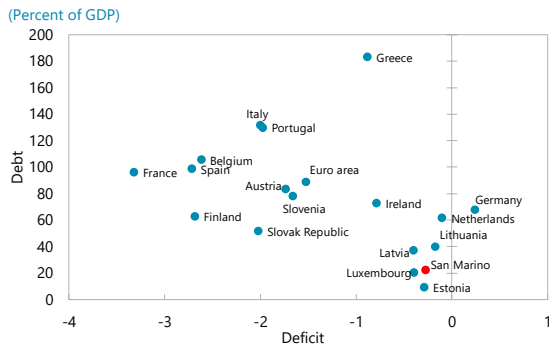
...and lower need to borrow than euro area countries.

Government Gross Debt, 2016
(Percent of GDP)



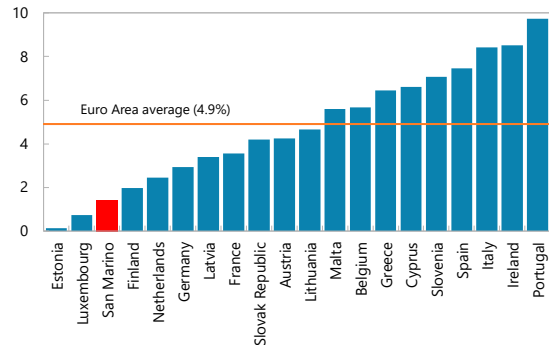
Public debt to GDP was lower than the level observed for euro area countries in 2016...

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



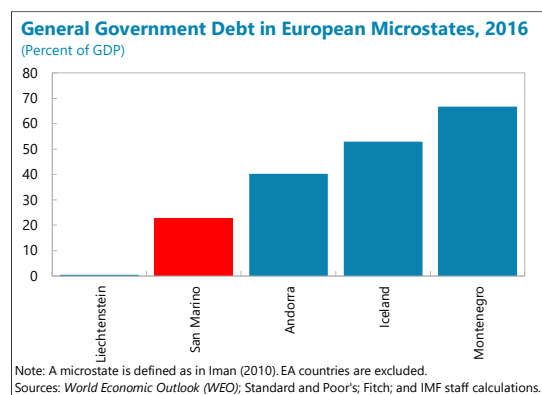
...which explains the low interest payments.

Interest Payments, 2016
(Percent of government revenue)



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

3. Public debt and interest payments have remained comparably low up to 2016. A history of low deficits has manifested in less need for borrowing and San Marino's public debt stood at 23 percent of GDP in 2016. This was relatively low when compared to the euro area average of 79 percent (Figure 1),¹ and other European microstates (Text Figure). Low public debt in San Marino was reflected in low interest payments, which were around 0.3 percent of GDP in 2016, and accounted for 1.4 percent of government revenue (Figure 1). This was only around one third of the average observed across euro area countries.



4. The public debt stock is mainly financed by long-term loans. In 2016, around 75 percent of the debt stock was financed through longer term loans. Net account payables made up close to 20 percent of the debt stock, and the remaining 5 percent were accounted for by short-term loans. The debt was predominantly issued to domestic investors.

5. Going forward public debt is bound to rise due to bank recapitalization.

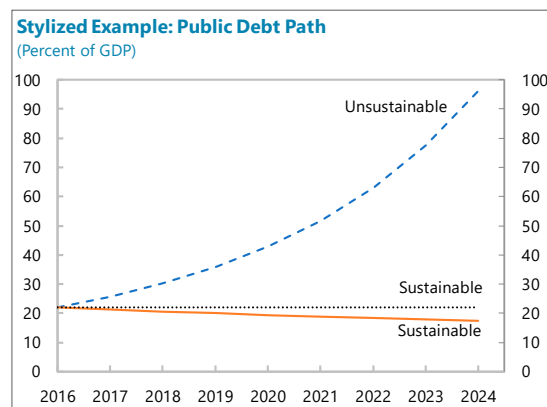
The government has committed to amortize the 2016 loss (36 percent of GDP) made by the state-owned bank Cassa di Risparmio della Repubblica di San Marino (CRSM) over the next 25 years. This recapitalization need may be revised following the ongoing Asset Quality Review (AQR) update. Nevertheless, given current information, the debt-to-GDP ratio is set to rise above 50 percent of GDP, which is an unprecedented level for San Marino.

6. Rising public debt increases the need to develop debt management capacity.

The government has already included adjustment measures in the 2018 budget to contain the increase in the debt-to-GDP ratio. Going forward, it will be important to develop capacity to conduct debt sustainability assessment in-house. This will aid the formulation of a medium-term fiscal framework including setting a target for the debt-to-GDP ratio and calibrating necessary adjustments to reach such a target.

B. Considerations for Debt Sustainability

7. Conducting a debt sustainability analysis is important to ensure that fiscal policy is available when needed. A high level of debt could constrain the ability of the government to support growth and provide a social safety net when negative shocks hit the economy. Excessive debt may ultimately require corrective measures, including cuts in important spending items.



¹ The average was 66 percent when excluding the three countries with the highest debt (Greece, Italy, and Portugal).

8. In general, a country’s public debt path can remain sustainable under a temporary increase if coupled with a credible adjustment plan to reach an appropriate target. A path with a temporary increase in the debt stock can be sustainable if subsequent adjustments are expected to stabilize the ratio at an appropriate target. This adjustment needs to be feasible without relying on an overly ambitious path for revenue and spending.

9. Formulation of an appropriate debt target is a function of several variables and requires an element of judgement. In general, a country can stabilize its debt at a higher level if growth is higher or financing costs are lower. More concretely, for a given primary balance, a country can attain an unchanged debt to GDP level at a higher level if the economy is growing at a higher rate, or the effective interest rate on its debt stock is lower.² At the same time, a more developed access to global capital markets can lower the risk of “sudden stops” in the country’s access to financing. Moreover, a diversified economy provides a hedge against large sudden drops in the debt servicing ability of the government. For Advanced Market Economies (AEs) countries with market access, the IMF applies a threshold of 85 percent of GDP, above which the risk of debt distress is considered elevated (IMF, 2013). For Emerging Markets Economies (EMs) the threshold is 70 percent of GDP. However, using these thresholds may not be appropriate for San Marino given its untested market access.³ To assess a debt target for San Marino, Section D below will take account of the interest rate burden and the size of fiscal adjustments associated with various debt levels.

C. Scenario Analysis

10. Staff has analyzed several scenarios for the public debt of San Marino. Baseline assumptions are as follows: Nominal (real) growth is projected to be 2.9 (1.3) percent in 2018, and settle at 2.7 (1.3) percent in the medium term. The overall fiscal balance is assumed to be -0.3 percent of GDP in 2018 before reaching 0.6 percent in 2020. The average interest rate is projected to be around 2 percent.⁴ The baseline scenario also assumes measures envisaged in the 2018 budget, including extraordinary taxes and some current spending cuts.

11. The 2016 loss of CRSM is included in government debt in the baseline scenario. CRSM booked only a €54 million loss in 2016 out of the full €536 million loss, taking advantage of Decree-Law 101, which allows banks to spread losses over up to 30 years. The government initially announced that the full loss will be amortized using public money over 25 years. Even though specific modalities are yet to be defined and there is uncertainty about the eventual loss amount depending on the ongoing AQR results, the baseline scenario (Scenario 1) treats the CRSM’s full loss as a newly incurred liability for the central government in 2017 for analytical purposes. Specifically, given that €41 million out of €54 million has been addressed through a conversion of hybrid bonds

² To see this notice that the primary balance (pb) needed to stabilize a given debt to GDP ratio (b) can be written as $pb \approx (r-g)*b$.

³ In the past, the government of San Marino has issued government bonds for a total of EUR 135 million at three occasions in 2013 and 2016. But these were domestic bonds, primarily bought by domestic banks.

⁴ This assumes continued availability and reliance on domestic funding.

into equity, the remaining amount of roughly €490 million (30 percent of GDP) is added as a new public debt in 2017 in the following analysis (Table 1).⁵

12. Contingent liabilities stemming from conversion of tax credits into government bonds are also considered. Decree-Law 93, approved last summer, allows a possible conversion of tax credits to government bonds.⁶ The value of these tax credits is estimated at around 20 percent of GDP. The modalities of the conversion are still not worked out, but the access to upfront liquidity and potential interest rate payments could provide financial incentives for banks to trigger the conversion.

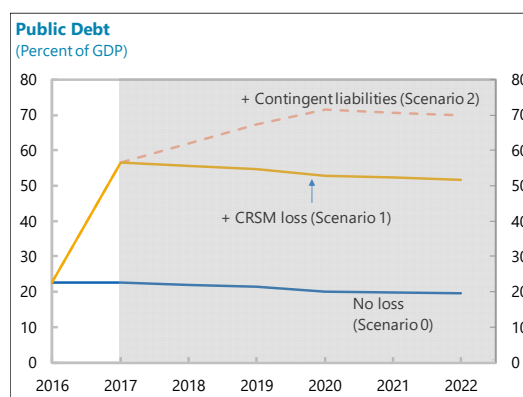
	€ million	Percent of GDP	Notes:
CRSM capital injection	13	1	€13 million out of the EUR54 CRSM recapitalization need in 2017 is planned to be met by capital injection by the government.
CRSM legacy loss	480	30	€480 (=534-54) is initially announced to be amortized over 25 years by the government. However, modalities are yet to be finalized. Scenario 1 and 2 below treat this as part of public debt
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 could be triggered by any banks which have accumulated tax credits in the past.
Total	793	51	

1/ Based on current information and staff estimate. Total final costs are highly uncertain.
Source: IMF Staff Calculations

13. In a baseline scenario where the government assumes the 2016 loss of CRSM (scenario 1), the public debt increases to 57 percent of GDP in 2017. This raises the debt path with some 30 percent of GDP vis-à-vis Scenario 0 in which the government is not assumed to cover the loss. The debt ratio gradually comes down to 52 percent of GDP by the end of the projection period.

14. In a scenario where the contingent liabilities materialize, the debt ratio increases further to

70 percent of GDP. In Scenario 2, the contingent liabilities stemming from conversion of tax credits are realized gradually during 2018–20. This pushes up the path for the debt ratio by some 20 percent of GDP and remains at about the same level by the end of the projection period.

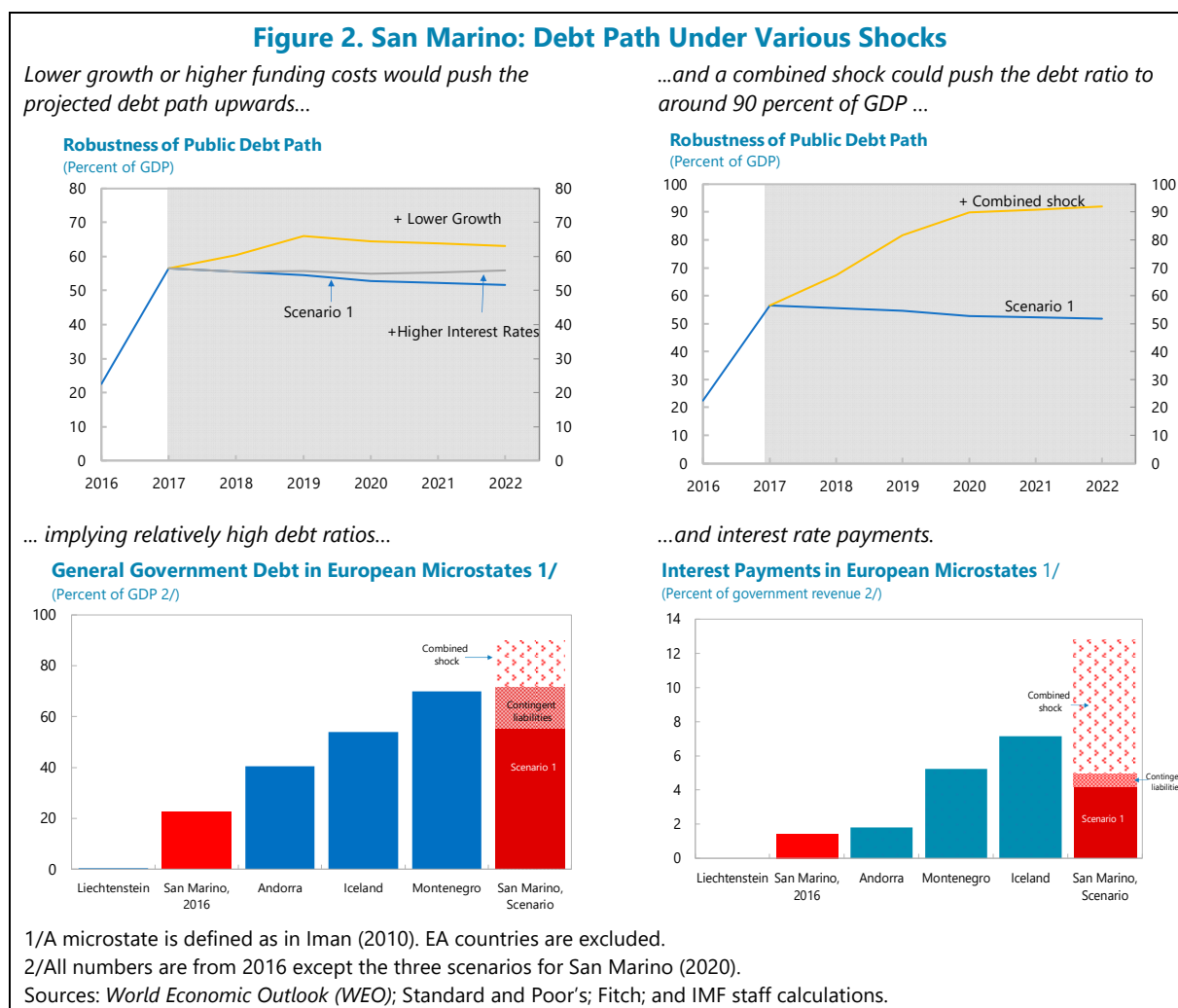


⁵ €8.5 million out of €13 million (54–41) was covered by capital injection in December 2017, with the balance to be injected in the first quarter of 2018.

⁶ The increase in gross debt caused by the conversion may to some extent be offset by an increase in future tax revenue, since a conversion means the banks will not be able to make tax deductions.

15. Additional shocks could push the debt ratio as high as 90 percent of GDP. To assess the robustness of the debt path under Scenario 1, the impact of other shocks is analyzed (Figure 2). First, a shock to growth of one standard deviation (5 percentage points) for two years could raise the debt ratio to 65 percent of GDP. Second, an increase in funding costs of 300 basis points⁷ during the projection period would increase the debt ratio to 55 percent and put the ratio on an upward sloping trajectory.⁸ Third, a combined shock to contingent liabilities, growth, and funding costs could increase the debt ratio to a level as high as 90 percent of GDP.

16. The projection of debt is subject to substantial uncertainty given lack of clarity about bank capital shortfalls and modalities for recapitalization. To the extent that more public money is required to recapitalize the banking system, the debt ratio could increase further. On the other hand, positive revisions of asset values in CRSM could also improve the outlook.



⁷ An increase in funding costs could happen if the government needs to seek external funding, which is likely to come at a higher interest rate than domestic funding.

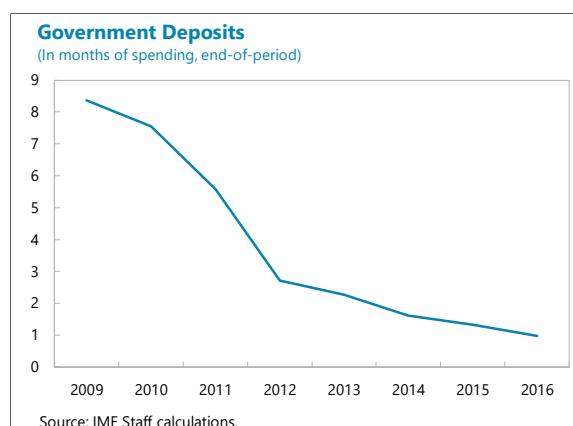
⁸ A key parameter in this scenario is the maturity of the debt taken to cover the CRSM loss. The shorter maturity assumed, the faster will be the spill-over of higher interest rates. In this shock scenario, an immediate spill-over is assumed. If no spill-over is assumed the debt-to-GDP ratio will only increase by around 0.5 percent of GDP.

D. Developing a Fiscal Strategy

17. What could be the medium-term fiscal strategy for San Marino faced with rising public debt? Specific fiscal adjustments and medium-term fiscal anchor are difficult to define at this point given high uncertainty about the final fiscal costs associated with banking sector repair. However, there are key considerations to be made in developing a fiscal strategy, including sustainable level of debt, interest payments, and fiscal buffers.

18. Debt ratios of 55–90 percent of GDP are unprecedentedly high for San Marino. Such levels would be well above the debt ratios observed in other European microstates, and should the debt ratio reach higher than 85 percent of GDP, it would be above the threshold for which the risk of debt distress is deemed to be elevated for AEs (IMF, 2013). In addition, a debt ratio in the interval of 55–90 would imply interest payments of 4–13 percent of revenue by 2020. This would be substantial, both in a historical context and compared with other European microstates. These considerations, together with San Marino’s limited market access argue that keeping the debt ratio well below the 85 percent threshold is desirable for San Marino.

19. Rebuilding government deposits as fiscal buffers should be also considered. The level of government deposits has been declining over the last years; from around eight months of spending in end-2009 to below one month of spending in end-2017. Albeit only slightly below the standard yardstick for fiscal reserve buffer of one month cover of spending (Wiegand, 2013), the level appears low given San Marino’s limited market access and relatively large financial sector. Thus, rebuilding government deposits should be also a key consideration in designing the necessary fiscal adjustments.



20. Fiscal adjustments could be formulated to create confidence that debt ratios will decline towards comfortable territory and deposits will be rebuilt. Specifically, designing a medium-term fiscal strategy could involve determining a target for the debt-to-GDP ratio and an associated target for government deposits. For illustrative purposes, the text table takes point of departure in Scenario 1 and shows the level of fiscal consolidation needed to reach various debt and deposits levels by 2022. For example, if the targets for the debt-to-GDP ratio and deposit cover are 50 percent and three months of spending, respectively, the government

		Debt ratio (percent of GDP)		
		50	40	30
Deposit level (months of spending)	1	0.4	2.4	4.4
	2	0.8	2.8	4.8
	3	1.1	3.1	5.1

Source: IMF staff calculations.

would need to consolidate by 1.1 percent of GDP vis-à-vis Scenario 1. Reforms that support growth will also be helpful in reducing debt ratios.

21. Fiscal adjustments needed to attain a given medium-term target are subject to uncertainty.

First, realization of the contingent liabilities could substantially raise the required consolidation to achieve a given debt to GDP level by 2022. Second, the impact of consolidation on growth would also matter, and a higher negative impact would increase the needed adjustment. The analysis above assumed no impact on the path of GDP for simplicity, while a higher negative impact on growth would raise the required consolidation to attain the given debt to GDP level in 2022.⁹ Relatedly, the projected growth path is subject to uncertainty with a lower (higher) growth path raising (lowering) the required consolidation. Third, higher funding costs would also raise the required consolidation.

Fiscal Adjustment to Meet a Given Debt Target			
Target debt ratio by 2022, (percent of GDP)			
	50	40	30
<i>No Shocks</i>			
Scenario 1	0.4	2.4	4.4
+ contingent liabilities	4.1	6.1	8.1
<i>One standard deviation lower growth</i>			
Scenario 1	2.7	4.6	6.6
+ contingent liabilities	6.7	8.6	10.6
<i>300 basis points higher interest rate</i>			
Scenario 1	1.1	3.3	5
+ contingent liabilities	5.0	6.9	8.9

Source: IMF staff calculations.

E. Conclusions

22. San Marino faces new fiscal challenges. Recent interventions in the financial sector are set to increase the debt to GDP level, although the eventual level of public debt remains highly uncertain. Based on the currently reported data, the government's commitment to cover the 2016 loss made by CRSM will increase the debt-to-GDP ratio by around 30 percent of GDP. At the same time, the government has granted banks the right to convert tax credits to government bonds, thus creating contingent liabilities.

23. Going forward a fiscal strategy is needed. The scenario analysis in this paper suggests that the debt-to-GDP ratio could rise to 55–90 percent of GDP. Such levels would be high for San Marino and well above the level observed in other European microstates. At the same time, government deposits have been decreasing to a low level. A medium-term fiscal strategy could thus aim at containing the debt-to-GDP ratio and rebuilding deposits. The analysis in this paper offered considerations that could be helpful in determining fiscal adjustments needed to reach such targets.

⁹ Batini et al. (2014) discuss how to calibrate an appropriate multiplier.

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