INTERNATIONAL MONETARY FUND

IMF Country Report No. 19/85

REPUBLIC OF SAN MARINO

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR THE REPUBLIC OF SAN MARINO

March 2019

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 2019 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, 2019 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, 2019, following discussions that ended on February 1, 2019, 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 5, 2019.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for the Republic of San Marino.

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

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International Monetary Fund
Washington, D.C.

Press Release No. 19/91
FOR IMMEDIATE RELEASE
March 26, 2019

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

IMF Executive Board Concludes 2019 Article IV Consultation with the Republic of San Marino

On March 22, 2019 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino.

San Marino's growth momentum moderated in 2017 on the back of weak external demand and increased financial sector uncertainties, which contributed to sizable deposit outflows. Deposit outflows have abated in recent months, yet the banking system's fragilities remained elevated owing to poor asset quality, sizable capital shortfalls, high operating costs, and low liquidity. Repeated capital injections to the state-owned bank, Cassa di Risparmio della Repubblica di San Marino, contributed to persistent fiscal deficits, while a full and upfront cost recognition of past bank interventions by the state poses significant stability risks.

San Marino made progress in improving the business climate and increasing labor market flexibility, yet—absent swift and significant policy actions to restore banking system viability, support credit conditions, and mitigate fiscal risks—growth prospects are projected to remain weak. Real GDP is projected to grow by one percent on average in 2018–19, supported by exports and investment while final consumption is set to further contract as household continue to deleverage. Over the medium term, growth is projected to further moderate as the completion of the investment project in 2019 and tight credit conditions will drag down investment growth, while less favorable external conditions will lower export growth. Elevated financial and fiscal fragilities pose significant downside risks, especially given the central bank's low liquidity buffers, inadequate powers and tools, and lack of external market access.

Executive Board Assessment[2]

Executive Directors agreed with the thrust of the staff appraisal. They noted that deep rooted weaknesses in the banking system have dampened credit conditions, undermined economic activity, and are now threatening financial stability and fiscal sustainability. Directors

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

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

emphasized that upfront recapitalization and restructuring of the banking sector, growth friendly fiscal consolidation, and structural reforms are urgently needed to shift the economy to a sustainable growth path.

Directors stressed the importance of safeguarding central bank liquidity buffers, including by aligning the emergency liquidity assistance framework with international best practice and restricting the central bank's budget financing to only exceptional needs and on a temporary basis. Developing a well crafted communication strategy is also crucial to effectively respond to a potential resurgence in liquidity pressures and protect the payment system.

Directors underscored that it is important to address banking system fragilities and restore its viability. They underlined the need for a deep restructuring, including through significant cost reduction and durable resolution of the high level of non performing loans, enhancement of bank liquidity positions, and a recapitalization that relies on a mix of public support and private contributions. Converting tax credits into government bonds is also essential to restore banking system viability. Directors stressed the importance of enhancing the central bank's powers and strengthening its capacity to oversee the banking system and called for reviewing the central bank law to increase its accountability, governance, and independence. They welcomed the progress in strengthening the framework for anti money laundering and combating financing of terrorism while noting that further efforts are needed to contain financial integrity risks.

Directors stressed the need to contain government's contribution to banks' recapitalization and adopt a credible fiscal consolidation strategy, which relies on indirect tax and pension reforms, rationalization of tax rebates, and improvement of spending efficiency. They noted that successful adoption of the VAT will play an important role in broadening the tax base and mobilizing revenues. Directors urged the authorities to strengthen debt management capacity and diversify financing options to reduce fiscal risks.

Directors stressed that addressing structural impediments and expanding market access is important to promote higher growth. They welcomed the recent measures to relax the hiring of nonresidents and underscored that further efforts to enhance the business environment, improve labor market flexibility, and close infrastructure gaps would boost San Marino's growth potential. Directors supported the authorities' efforts to increase economic integration with the European Union.

Directors welcomed the progress made in data provision and encouraged the authorities to further improve the frequency, coverage, and reporting of relevant statistics.

San Marino: Selected Economic Indicators, 2015–20

	2015	2016	Est. 2017	Projection 2018	2019	2020
Activity and Prices						
Real GDP (percent change)	2.5	2.5	0.6	1.1	0.8	0.7
Unemployment rate (average; percent)	9.2	8.6	8.1	8.0	8.1	8.1
Inflation rate (average; percent)	0.1	0.6	1.0	1.6	1.6	1.7
Public Finances (percent of GDP) 1/						
Revenues	23.0	23.3	22.1	22.9	20.9	20.9
Expenditure	26.3	23.4	25.7	25.7	23.3	24.0
Overall balance	-3.3	-0.2	-3.6	-2.7	-2.4	-3.0
Government debt (Official)	21.8	24.0	25.9	27.5	28.8	31.0
Government debt (incl. CRSM legacy losses and tax credits)	33.5	35.2	76.6	77.0	77.1	77.9
Money and Credit						
Deposits (percent change)	-6.7	-5.6	-12.3	-1.5	...	...
Private sector credit (percent change)	-6.6	-5.1	1.1	-2.9	...	...
Net foreign assets (percent of GDP)	182.9	161.1	138.1	133.0	...	...
External Accounts (percent of GDP)						
Current account balance	...	...	-0.5	0.4	0.4	0.2
Gross international reserves (millions of euros)	348.1	427.8	252.7	252.5	...	...
Financial Soundness Indicators (percent)						
Regulatory capital to risk-weighted assets	12.7	11.5	13.7	...	...	...
NPL ratio 2/	52.6	50.0	54.0	...	...	...
NPL coverage ratio 2/	28.7	54.8	56.0	...	...	...
Return on equity (ROE)	-9.0	-13.2	-10.0	...	...	...
Liquid assets to total assets	29.8	28.0	22.7	...	...	...
Liquid assets to short-term liabilities	58.9	53.0	40.6	...	...	...

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

1/ For the central government.

2/ CBSM supervisory data. 2017 data do not reflect 2017 AQR results.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

March 5, 2019

KEY ISSUES

Context: Deep-rooted weaknesses in the banking system have undermined economic activity and are now threatening financial stability and fiscal sustainability. Significant deposit outflows have left the banking system with low liquidity, while persistent losses and high non-performing loans (NPLs) resulted in sizable recapitalization needs, particularly in the state-owned bank. The central bank of San Marino (CBSM) and government liquidity buffers are low, and a full and upfront recognition of the state's excessive commitments to the banking system would make public debt unsustainable. A comprehensive strategy is urgently needed to shift the economy to a sustainable growth path.

Outlook and risks: Growth is projected to remain subdued in the coming years, reflecting continued banking sector deleveraging and a less favorable external environment, most notably in Italy. Slow progress in repairing the banking sector, and full and upfront recognition of the state's financial commitments to the banking system are the key risks.

Main policy recommendations: Urgent actions are needed to restore banking sector viability and credit supply, safeguard public finances, and promote sustained economic growth.

- **Financial sector**: Improve liquidity management and finalize a strategy that consists of upfront loss recognition and bank recapitalization, restructuring and downsizing to return banks to viability, durable NPL resolution, and measures to strengthen bank oversight and governance. Require banks to raise fresh capital based on the findings of the Asset Quality Review and provide state support only to systemically-important and viable banks following burden sharing.
- **Fiscal policy:** Restore public debt sustainability by implementing an ambitious and growth-friendly fiscal adjustment that relies on revenue and expenditure measures, including VAT implementation, targeted pension reform, and improved spending efficiency. Develop debt management capacity and diversify financing options.
- **Structural reforms**: Strengthen labor supply by better targeting social benefits and further relaxing the hiring process of nonresidents. Address infrastructure weaknesses, improve further the ease of doing business, and increase international economic integration to sustain economic diversification and expand market access.

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

Discussion were held in San Marino on January 23–February 1, 2019. The team comprised Messrs. Klein (head), Dell'Erba, Muraki, (all EUR), Comelli (SPR), and Monaghan (MCM). Mr. Spadafora (OED) participated in the discussions. The team met with the heads of State, Secretary of State for Finance and Budget, Central Bank President, other cabinet members and central bank officials, private sector representatives, and social partners. Ms. Burova and Mr. Velazquez-Romero (both EUR) assisted the mission from headquarters.

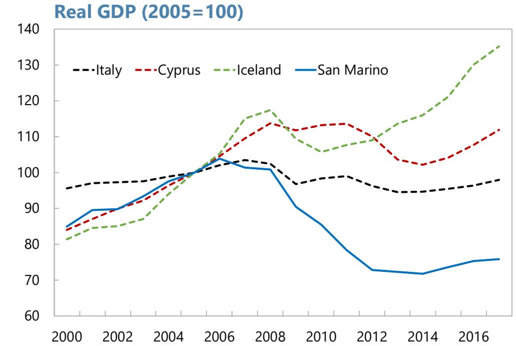
CONTENTS

ANNEXES

CONTEXT

1. Economic activity has yet to recover from the sharp downturn in the past decade. The collapse of San Marino's offshore banking model, largely due to anti-tax evasion measures by Italy, as well as weak external demand and tight credit conditions in the post-crisis period led to a loss of a third of its output—among the deepest recessions in Europe. Activity bottomed out in 2015–16, but the pace of the subsequent recovery has been subdued.

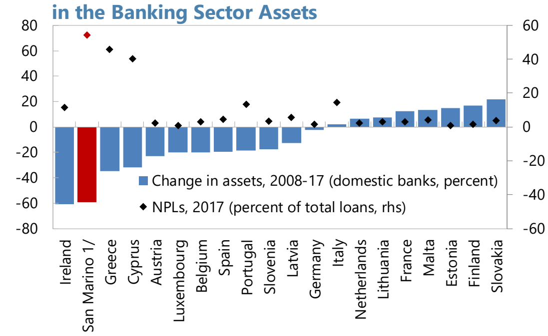
Real GDP (2005=100)



Sources: World Economic Outlook.

2. Vulnerabilities have increased, owing to fragilities in the banking system and excessive use of forbearance. The over-sized banking sector has been shrinking and left with low liquidity due to deposit outflows, mainly by non-residents. High NPLs and elevated operating costs have eroded banks' capital and viability, leading to multiple bank resolutions over recent years, but the losses have yet to be properly recognized and absorbed. Multiple state supports have been provided to the state-owned bank, Cassa di Risparmio della Repubblica di San Marino (CRSM), yet its capital base remains deeply negative. A full and upfront cost recognition of past bank interventions will increase public debt substantially to an unsustainable level. This, together with low CBSM liquidity buffers and lack of external market access, threatens financial stability. Recognizing the gravity of the challenges ahead, the authorities are discussing how to restore banking system viability and safeguard public finances with local stakeholders. Progress, however, has been slow as domestic politics and limited administrative capacity are challenging.

Non-performing Loans and Cumulative Change in the Banking Sector Assets

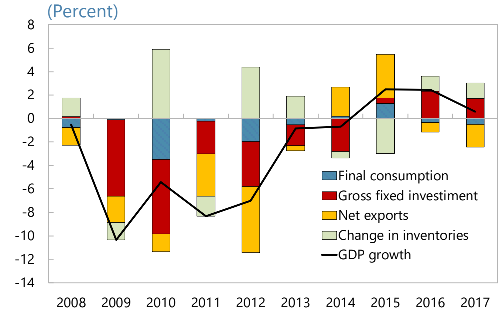


1/ San Marino's NPL figure indicates the pre-AQR ratio.
Sources: ECB, CBSM, and IMF staff.

RECENT DEVELOPMENTS AND POLICY PRIORITIES

3. Economic recovery lost momentum in 2017. Real GDP growth moderated to 0.6 percent in 2017 from an expansion of 2.5 percent in 2016 as the contraction of exports and final consumption partly offset buoyant investment. High frequency indicators paint a mixed picture for 2018 as the relaxation in labor market restrictions ("Development law", 2017) boosted cross-border workers.[1] Nevertheless, the unemployment rate

Real GDP Growth
(Percent)

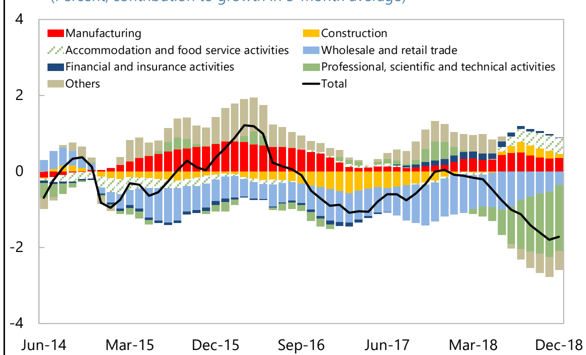


Source: Sammarinese authorities and IMF staff.

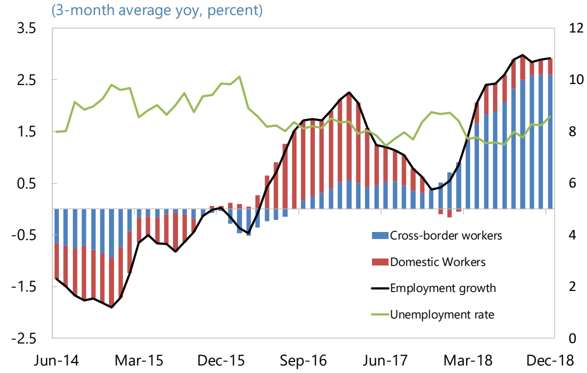
[1] Preliminary GDP estimates for 2018 will be available at end-2019.

edged up to above 8 percent (December) after moderating in the first half of the year, while the number of enterprises further contracted. Headline inflation picked up and then retrenched to about 1.6 percent reflecting volatile food and transport costs, but core inflation remained broadly stable at 0.7 percent (December).

Number of Enterprises
(Percent, contribution to growth in 3-month average)



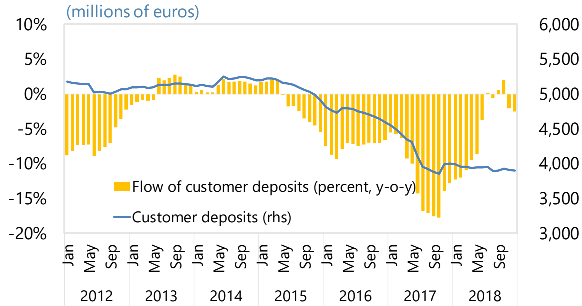
Unemployment Rate and Employment Growth
(3-month average yoy, percent)



Source: Sammarinese authorities.

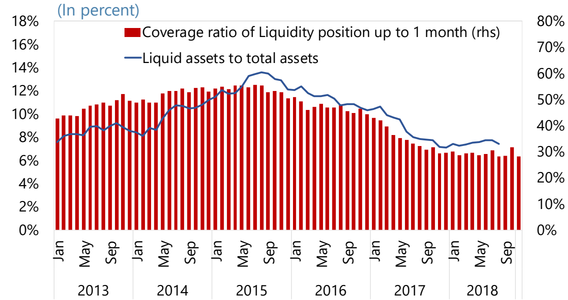
4. Deposit outflows have abated in 2018, but banking system liquidity remains at highly vulnerable levels. Liquid assets-to-short-term deposits have almost halved since mid-2015 and two banks have been chronically reliant on emergency liquidity assistance (ELA) from the CBSM. Recently, one bank repaid ELA following one-off asset disposals, while the other was put under special administration and is subject to monthly deposit withdrawal limits as its liquidity has been depleted. Additionally, banks have benefitted from substantial waivers from minimum reserve requirements with two banks receiving a full exemption. Continuous financing provided to banks and government contributed to a decline of about 40 percent in CBSM reserves relative to their end-2016 level.

Banking System Deposits
(millions of euros)



Note: Customer deposits include certificates of deposits (CDs). Customer deposits of Asset Banca are excluded since June 2017, when it was placed under compulsory administrative liquidation, until its assets were transferred to CRSM at end-October 2017.
Sources: CBSM and IMF staff.

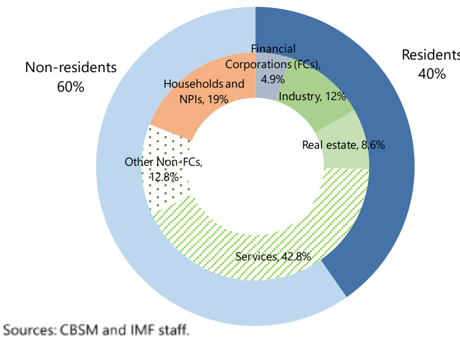
Banking Sector Liquidity
(In percent)



Note: Coverage ratios are liquid assets plus net interbank loans as a share of customer deposits and financial instruments. Liquid assets include cash, financial assets (other than interbank loans) that are available within 7 days and securities that can be readily converted to cash.
Sources: CBSM and IMF staff.

5. The banking system's recapitalization needs are sizable and asset quality is low (Annex I). The estimated capital shortfalls stand at 39 percent of GDP (54 percent of GDP when tax credits are included). Higher capital levels will be required under the application of the EU standards, which are expected to be transposed in 2019 with a yet-to-be-determined transition period. While the asset quality review (AQR) was completed several months ago, the CBSM has commenced discussions on findings with banks, but the diagnostic results are becoming outdated. Even after the recent sale of Delta sub-portfolio, NPLs, which are largely related to failed SMEs in the services sector, remain high at around 55 percent of total loans (post-AQR), thus weighing heavily on financial intermediation and profitability.

Non-performing loan distribution
(precent of total NPLs, net of provisions, September 2018)



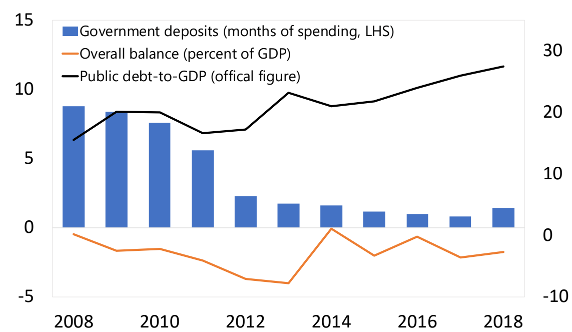
Sources: CBSM and IMF staff.

6. Persistent losses further eroded banks' capital position. The banking system is estimated to have registered a loss in 2018—for the ninth year in a row—reflecting high operating costs, high NPL costs, and non-interest-bearing tax credits (15 percent of GDP) given to banks to cover the asset-liability gap when they absorbed failed banks.[2] The recent decision to repeal banks' option to convert tax credits into government bonds implies that these tax credits will continue to weigh on profitability and act as a deterrent to raising capital from private sources.

7. Efforts to develop a financial sector strategy continue, but progress is slow. This reflects the divergent views among stakeholders of how to allocate the substantial losses, the lack of appetite to implement the needed reforms, and the inability to reach consensus on the future structure and role of the San Marino banking system. The CBSM is making progress on several fronts that will promote financial stability, but lack of sufficient powers, autonomy, and consultation on financial sector-related policies hinder its effectiveness. A court decision in late 2018 to annul the CBSM's intervention and resolution of Asset Banca in 2017 may complicate issues further.

8. Fiscal buffers remain low amid sustained fiscal deficits. The overall fiscal deficit is projected to have narrowed to 2.7 percent of GDP in 2018 from 3.6 percent of GDP in 2017 as one-off revenue measures, including a wealth tax, helped offset the state support to CRSM (about 3 percent of GDP). The fiscal deficit is projected to have contributed to a further increase in the official public debt figure to about 27.5 percent of GDP in 2018 and to continued low levels of government deposits at the CBSM. The inclusion of government's commitments to the banking system (CRSM's legacy losses and the banking system tax credits), suggests that the implicit public debt stood at about 77 percent of GDP in 2018 (Annex V).

Fiscal Buffers and the Overall Fiscal Balance



Sources: MoF and IMF staff.

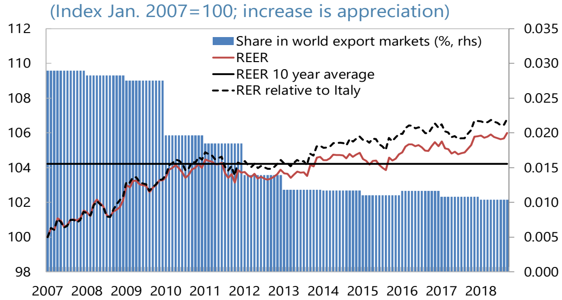
[2] Five banks were issued €211 million of tax credits, with about half allocated to CRSM. These perpetual instruments, which may increase over time during semiannual revaluations of the NPLs of failed banks, can be used only to offset future tax liabilities. However, the tax credits are unable to generate income or absorb losses, are not marketable or transferrable, and would possibly result in a cost to the state should a bank be liquidated.

9. The external position is weaker than implied by fundamentals and desired policy settings (Box 1). San Marino recently produced its first balance of payment and International Investment position (IIP) statistics. While caution is needed as monitoring cross-border shopping remains difficult, the 2017 current account balance points to a deficit of 0.5 percent of GDP. Large liquidation of foreign portfolio investments by banks and a decline in loans of domestic banks to nonresidents resulted in a decline in the net IIP to 261 percent of GDP in 2017 from 270 percent in 2016. The real effective exchange rate (REER) remined broadly stable in 2018 at about two percent above its 10-year average following a prolonged appreciation.

Box 1. External Sector Assessment

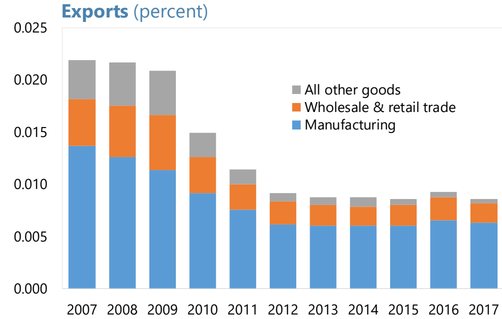
San Marino's market share declined considerably in recent years. San Marino lost about two-thirds of its world export market share compared to the pre-crisis period due to weak recovery in Italy, and significant reduction in exports of goods, including manufacturing. The loss in export market share occurred simultaneously with a prolonged appreciation of the REER on account of a persistent and widening positive inflation differential vis-à-vis Italy. This, along with the remaining structural impediments (see structural policies), suggests that improving competitiveness remains a key challenge for San Marino.

CPI-Based REER and Export Market Share
(Index Jan. 2007=100; increase is appreciation)



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

Share of San Marino's Exports of Goods in World's Exports (percent)



Sources: San Marino authorities and IMF staff.

Based on the IMF's EBA-lite methodology, staff assess that San Marino's external position is weaker than implied by fundamentals and desirable policy settings. While significant data weaknesses call for caution, both the Current Account (CA) gap and REER Index models suggest an overvaluation, albeit with different magnitude. Specifically:

Current Account (CA) gap model: The CA gap model indicates a "CA norm" of a surplus of 3.1 percent of GDP that largely reflects the relatively high net asset position of the economy relative to its key trading partners. This results in a CA gap of a -3.6 percent of GDP—consistent with an REER overvaluation of 3.2 percent. The current account gap is largely explained by a policy gap, notably, slow progress in addressing banking sector fragilities and in fiscal consolidation that contributed to loss of international reserves recorded by the CBSM. This loss was mostly driven by the decline in commercial banks' and government's deposits in 2017.

San Marino. External Balance Assessment, 2017

a	Actual CA	-0.5%
b	CA norm	3.1%
c	**CA gap = [a]-[b]**	**-3.6%**
	o/w policy gap	-4.1%
d	Elasticity	-1.1
e	**REER gap = [c]/[d]**	**3.2%**
f	Fitted CA	-1.0%
g	Residual = [a]-[f]	0.4%

Source: IMF staff.

REER Index model: The REER appears to be overvalued by 2.2 percent, suggesting that the REER is somewhat stronger than implied by fundamentals. The lower equilibrium level largely derives from lower credit level and growth in San Marino compared to its trading partners' averages, thus indicating that San Marino's REER should depreciate to be in line with its fundamentals.

OUTLOOK AND RISKS

10. Growth is set to remain subdued owing to weak domestic and external demand. Staff's baseline envisages an unsustainable "muddling-through" scenario, wherein the fundamental problems in the banking system are not fully addressed and economic conditions gradually deteriorate. Under this scenario, which assumes gradual banking system recapitalization, low liquidity, and continued contraction of bank balance sheets, real GDP is projected to grow by one percent on average in 2018–19, supported by exports and investment related to the construction of a large shopping center. Final consumption is projected to further contract as households continue to deleverage.[3] Over the medium-term, growth is expected to converge to 0.5 percent as the completion of the investment project in 2019 and tight credit conditions will drag down investment growth, while less favorable external conditions will lower export growth. CBSM reserves, which are already below adequate levels, are projected to decline gradually, assuming no acceleration of deposit outflows. Unemployment is expected to remain elevated at about 8 percent, and inflation, which is largely driven by import prices, is set to modestly increase.

San Marino: Macro Projections, 2017–24

		Projection						
	2017	2018	2019	2020	2021	2022	2023	2024
Activity and Prices (percentage change)								
Real GDP	0.6	1.1	0.8	0.7	0.6	0.5	0.5	0.5
Domestic demand	3.4	-0.2	0.6	0.7	0.6	0.6	0.6	0.6
Final consumption	-0.9	-0.8	-0.7	0.0	0.0	0.1	0.1	0.1
Fixed investment	9.0	11.6	3.5	2.1	1.7	1.7	1.7	1.7
Exports	-1.1	2.8	2.0	1.7	1.6	1.6	1.6	1.6
Imports	0.0	2.4	2.1	1.8	1.7	1.8	1.8	1.8
Employment (percent change)	1.1	2.4	1.2	0.5	0.3	0.3	0.3	0.3
Unemployment	8.1	8.0	8.1	8.1	8.1	8.1	8.1	8.1
Inflation rate (average)	1.0	1.6	1.6	1.7	1.7	1.8	1.8	1.8
Current account (percent of GDP)	-0.5	0.4	0.3	0.1	0.1	0.1	0.1	0.2

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

11. Significant downside risks dominate the outlook (Risk Assessment Matrix, Annex II). Domestically, the main risk stems from slow progress in banking sector repair, which would weigh on credit conditions, undermine confidence, increase liquidity pressures, and potentially threaten financial and economic stability. A full and upfront recognition of the state's excessive commitments to the banking sector would exacerbate the already high fiscal risks, erode confidence, and increase vulnerabilities. It would also lead to higher debt-service payments, which would crowd-out productive spending and negatively affect medium-term growth. On the external side, weaker-than-expected growth in key trading partners, particularly Italy, would put a strain on export-oriented sectors and negatively affect residents working abroad.

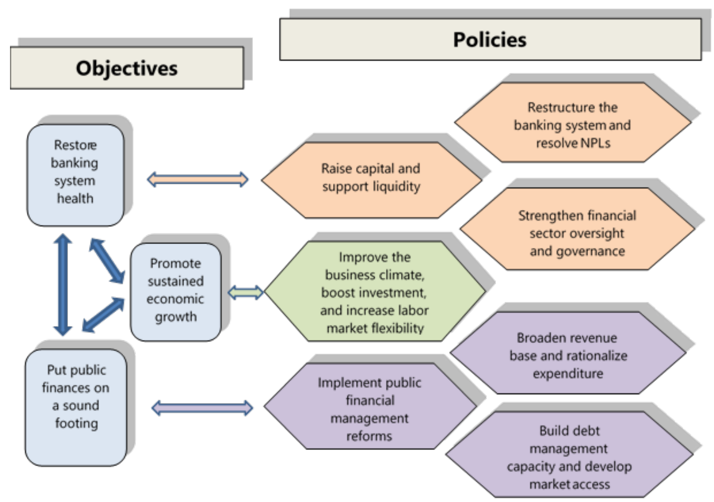
[3] Household debt, as measured by households' loans from the domestic banking system, declined to 41 percent of GDP in 2017 from 60 percent of GDP in 2013.

Authorities' Views

12. The authorities broadly concurred with staff's risk assessment but were confident that structural reforms and stronger cooperation with Italy will support growth. They agreed that a delayed action in repairing the banking system endangers financial stability while excessive state support to banks would undermine fiscal sustainability. However, they argued that the recent steps to ease nonresidents' hiring, which has already shown positive effects on employment, and further steps to improve the business climate could help attract foreign investment and shift the economy to a higher growth path. They also argued that the conclusion of the association agreement with the EU and the signing of the Memorandum of Understanding with the Bank of Italy could have significant benefits.

POLICY DISCUSSIONS

San Marino's key challenges are to simultaneously restore banking system viability and credit supply, safeguard public finances, and promote sustained economic growth. This requires deep banking system restructuring, including through significant cost reduction and durable resolution of NPLs, strengthening banks' capital and liquidity positions, and improvement of financial sector governance and oversight. The sizable bank recapitalization needs require a mix of private contributions and public support. An ambitious and growth-friendly fiscal consolidation and implementation of structural reforms would reduce vulnerabilities, improve competitiveness, and bolster potential growth.



A. Restoring Banking System Viability

Strengthening Banking System Liquidity and Capital Positions

13. Liquidity management should be urgently enhanced to preserve CBSM liquidity buffers. The CBSM has strengthened its liquidity monitoring and management framework. However, further efforts are needed to safeguard CBSM reserves, which are already below adequate levels (Annex III). The ELA framework needs to be aligned with best practice such that it will be restricted to fully-collateralized lending and provided only to solvent banks, contingent on approval of credible plans to repay loans at maturity. Well-developed measures and carefully crafted communication strategy are also urgently needed to respond to a potential resurgence in liquidity pressures and to safeguard the payment system. Limiting CBSM's budget financing to only exceptional needs and on a temporary basis would also support CBSM liquidity buffers.

14. There is a pressing need to address capital shortfalls in the banking system. The AQR findings should be incorporated into banks' financial statements and capital needs should be promptly addressed. The laws that allows banks to spread "AQR losses" over five years and protect subordinated debt holders should be repealed. The substantial recapitalization needs necessitate a mix of private and public contributions, with the amount of state support be guided by fiscal sustainability considerations (see ¶25). Specifically:

- **Private banks**. Private banks should first attempt to raise capital from private sources. Banks that cannot meet the minimum capital requirement within the prescribed timeframe should be subject to corrective action with only systemically-important and viable banks benefitting from state support.

- **State-owned CRSM.** CRSM is significantly undercapitalized, despite repeated state support in recent years. The government allowed CRSM's losses of €485 million (around 30 percent of total assets) to be spread over 25 years starting from 2016 and committed to recapitalize the bank with public money. Upfront loss recognition and recapitalization from public and private sources are needed to bolster confidence, improve bank governance, and resume lending to the real economy. This, together with timely and deep balance sheet restructuring, will support CRSM's return to profitability and re-privatization over the medium term.

Improving Efficiency and Profitability

15. San Marino's banking system requires deep restructuring to increase efficiency and restore profitability. The system is overbanked and its high average cost-to-income ratio points to significant inefficiencies (Box 2). Improved efficiency should focus on significant cost reduction, including measures to review employees' compensation and rationalize branch network. Plans to increase earnings through risky innovation projects should be resisted to avoid excessive risk taking and ensure the banking system soundness.

16. Tax credits on the banks' balance sheets should be converted to government bonds. These assets do not generate income, but must be funded, and thus weigh heavily on banks' viability and act as a deterrent to raising capital from private sources. Moreover, allowing the volume of tax credits to increase as recoveries from NPLs of failed banks fall introduces moral hazard and increases fiscal costs over time. Therefore, those tax credits should be converted into coupon-bearing government bonds to help restore banks' long-term sustainability.

Resolving NPLs

17. Advancing NPL resolution is a key to restore long-term viability of banks and support financial intermediation. To facilitate a faster NPL resolution, banks should quickly improve collection and workout capacity and engage more proactively in loan restructuring, settlement, and sales of both collateral and NPLs. These efforts should be monitored by supervisors and supported by initiatives to remove legal, regulatory, and tax impediments, including by:[4]

[4] The 2016 Selected Issues Paper provides a comprehensive discussion on the impediments for NPL resolution.

- **Strengthening supervisory oversight** to ensure that banks develop credible NPL resolution strategies with ambitious and realistic NPL reduction targets. Expectations should be set on the adequacy of loan-loss provisioning and timeliness of write-offs.

- **Expediting and maximizing recovery values through liquidation and enforcement**, including by streamlining the administrative processes, lowering taxes and fees related to enforcement, and adequately staffing the judicial system. The recent decision to fully liberalize the real estate market is expected to support improved collateral and NPL recovery values.

- **Facilitating rehabilitation for viable debtors** by modernizing the insolvency regime and increasing the flexibility of in-court restructuring agreements. The draft legislation to facilitate out-of-court debt restructuring is welcome yet wider creditor participation and stronger creditor protection would further improve its effectiveness.

- **Removing tax disincentives for NPL disposal** by relaxing the cap on tax deductibility of loan-loss provisions and eliminating time limits for tax deductibility of write-offs as well as the transaction tax on debt transfers.

Strengthening Financial Sector Oversight and Reducing Risks

18. Bank resolution framework urgently needs to be overhauled. The CBSM's resolution tools are limited, only allowing an intervention in failing banks to exercise a recovery operation or wind them down. Bringing CBSM resolution framework to international standards, including by providing it with purchase and assumption and bridge bank tools, strengthening its bank liquidation powers, and allowing greater flexibility with burden sharing options, would enable more effective interventions.

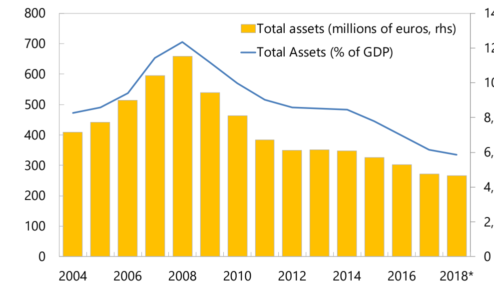
19. Reforming the CBSM, enhancing regulations and supervision, and improving communications are critical to safeguard financial stability. Banking supervisors need sufficient powers and adequate resources to implement the financial sector strategy, carry out regular bank inspections, and monitor systemic risks. Moreover, reviewing the CBSM law with a view of enhancing its independence, governance, accountability, and transparency as well as establishing macro-analysis, crisis management, and communication functions are a priority.

20. Sustained efforts are needed to contain financial integrity risks. The authorities reported the transposition of the 4th EU Anti-Money Laundering (AML) Directive to national laws, implementation of risk-based supervision by the Financial Intelligence Agency (FIA), and strengthening of AML/CFT legal and regulatory frameworks following the AML National Risk Assessment and Action Plan. Recent peer review report on the Exchange of Information on Request published by the OECD Global Forum upgraded San Marino's overall rating from "Largely Compliant" to "Compliant" while the EU removed San Marino from its tax haven gray list. Continuous efforts are needed to mitigate financial integrity risks, including through implementing the OECD's Base Erosion and Profit Shifting actions, strengthening FIA-police collaboration, and improving the effectiveness of transaction monitoring by financial institutions. The authorities' plan to prepare a second National Risk Assessment is a step in the right direction.

Box 2. San Marino's Banking Sector Structure

The Sammarinese banking system has shrunk substantially in the post-crisis period. A large deposit withdrawal, predominantly by non-residents in response to the Italian authorities' anti-tax evasion measures, led to a significant deleveraging of the Sammarinese banking system. Nonresidents' deposits declined by nearly 90 percent and, consequently, residents' deposits now account for most of total deposits and financial instruments issued to customers (85 percent at end-2018). Following several mergers and liquidations, the number of banks in operation halved from twelve to six, and banks' total assets declined to 335 percent of GDP in late-2018 from 706 percent in 2008.

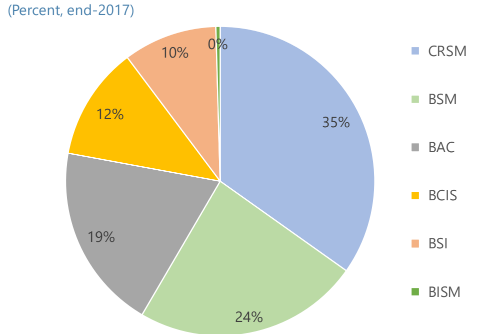
Banking System Assets



*As of November 2018.
Sources: CBSM and IMF staff.

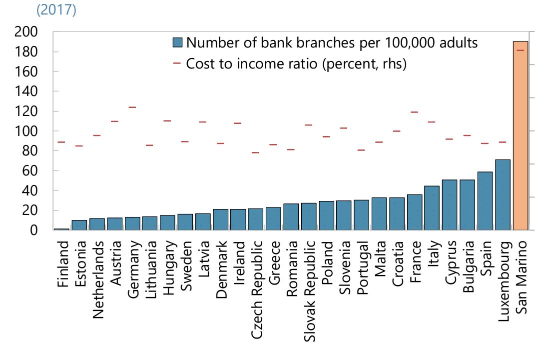
The remaining banking system assets are concentrated in a few large banks. Among the six banks operating in San Marino, the two largest—the state-owned CRSM and Banca di San Marino (BSM), which is owned mainly by a non-profit organization—account for nearly 60 percent of the banking system's total assets. The other banks are private with shareholders in both San Marino and abroad.

Banks' asset share
(Percent, end-2017)



Sources: CBSM and IMF staff.

Banking sector efficiency
(2017)



Sources: CBSM, IMF Financial Access Survey, and IMF staff.

The slow restructuring process has led to an inefficient banking sector, contributing to persistent losses. Despite the significant banking system deleveraging, San Marino is still overbanked with the number of branches per adult being the highest in Europe. High overhead costs alongside declining revenue have pushed the cost-to-income ratio to a high level of 108.4 percent and, together with substantial provisioning needs, contributed to persistent banking sector losses and erosion of capital.

Authorities' Views

21. The authorities recognized the urgency of addressing banking sector vulnerabilities but highlighted challenges. They expressed constraints in reaching agreement on a financial sector strategy with all stakeholders due to the substantial banking sector recapitalization costs and favored a gradual approach to bank recapitalization to mitigate the fiscal impact. The authorities argued that burden sharing, including applied to subordinated debt, is seen as a contentious issue and noted the necessity to fully guarantee the pension deposits to boost confidence and relieve liquidity pressures. They acknowledged that banks must improve efficiency, including through a substantial cost reduction. The CBSM recognized the urgency of improved powers and tools to effectively deal with failing supervised entities and to reduce potential fiscal costs. They also highlighted that recent actions, including improving banking system liquidity management and the AQR disclosure process, are important steps towards restoring the banking system's health. In the near term, they plan to examine banks' proposed recapitalization programs, strengthen bank oversight and governance, and take steps to accelerate NPL reduction while increasing cooperation with the Bank of Italy. The government, as the main shareholder of CRSM, is aware of the need to recognize losses as well as recapitalize and restructure the bank so that it returns to viability and contributes to the real economy, and noted that a system-wide approach to reduce NPLs is being prepared by the banks.

B. Safeguarding Public Finances and Ensuring Debt Sustainability

22. The 2019 budget aims to achieve a balanced position, net of government transfers to CRSM. The budget introduces new measures, which are projected to partly offset the expired one-off measures in 2018, and keep the fiscal position, excluding transfers to CRSM, broadly balanced. Nevertheless, it partly relies on one-off measures such as building regularization and tax on companies' real estate while the reduction in transfers to the Institute of social security (ISS), which continues to record sizable deficits, is not sustainable without further pension reforms (Annex VI).[5]

23. The projected state transfers to CRSM are likely to result in a sizable deficit in 2019. The budget includes an allocation to CRSM of €10 million, in line with the pre-determined amortization of its legacy losses. Considering also staff's estimate of the total allocation to CRSM, the deficit is projected to be significantly higher at 2.4 percent of GDP, which—with no fiscal adjustment in the course of the year—is expected to be largely financed by continued reliance on CBSM loans.

San Marino: Fiscal Projections, 2017–24

			Proj.					
Percent of GDP	2017	2018 Est.	2019	2020	2021	2022	2023	2024
Revenues	22.1	22.9	20.9	20.9	20.6	20.7	20.7	20.6
Expenditures	25.7	25.7	23.3	23.9	23.8	23.8	23.7	23.6
of which bank support	3.0	3.2	2.4	2.2	2.0	1.8	1.7	1.5
Overall Balance	-3.6	-2.7	-2.4	-3.0	-3.2	-3.0	-3.0	-3.0
Primary Balance	-3.3	-2.3	-2.0	-2.5	-2.6	-2.3	-2.2	-2.1
Primary Balance, net of bank support	-0.4	0.8	0.4	-0.3	-0.6	-0.5	-0.5	-0.6
Public debt (official)	25.9	27.5	28.8	31.0	33.6	36.0	38.3	40.6
Public debt (incl. tax credits and CRSM legacy losses)	76.6	77.0	77.1	77.9	78.0	78.1	78.2	78.3

Source: IMF staff.

24. A full and upfront cost recognition of past bank interventions would make public debt unsustainable. With a gradual recapitalization of CRSM and continued forbearance on the cost related to the banking system tax credits, the official public debt figure, which stood at 26 percent of GDP in 2017 is projected to creep up to about 41 percent of GDP in 2024. However, a full and upfront cost recognition arising from past bank interventions—namely CRSM legacy losses and tax credits given to banks for acquiring failed ones—would put public debt at an unsustainable level of

[5] The cut in transfers will require ISS to draw on its own reserves from the banking system. In no reform scenario, the ISS structural deficit is likely to drain these reserves by 2030 and potentially worsen banks' liquidity positions.

about 77 percent of GDP in 2017. At this level, gross financing needs would account for about one-third of total revenue, posing significant stability risks, especially given the low liquidity buffers, lack of market access, and limited debt management capacity (Annex V).

25. An ambitious fiscal adjustment that relies on both revenue and expenditure measures is needed to put public debt on a sustainable path and gradually build fiscal buffers. Staff's analysis indicates that a public debt of about 50 percent of GDP and government deposits covering at least two months of spending are appropriate medium-term fiscal anchors for San Marino.[6] This implies that banking system recapitalization would need to be supported by private contributions and an ambitious, but socially acceptable, fiscal adjustment. While the speed and magnitude of the adjustment will ultimately depend on the modalities of the banking system recapitalization strategy, staff consider sustaining a primary surplus (excluding bank support) of about 2.5 percent of GDP is feasible through both revenue and expenditure measures:

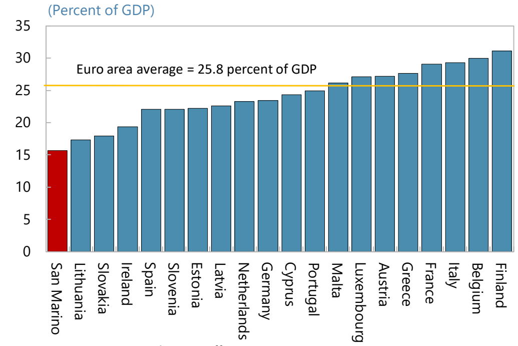
Possible Fiscal Adjustment Relative to 2018 1/

% of GDP	2019	2020
Tax Increase	**0.3**	**0.9**
VAT		0.6
Other revenue measures	0.3	
Spending Cuts	**0.1**	**0.8**
Pension Reform		0.5
Spending Review	0.1	0.3
Total Adjustment	0.4	1.7

1/ In cumulative terms.
Source: IMF staff and the authorities' National Stability and Development Plan.

- **Revenue**. With the tax-to-GDP ratio well below peers, reflecting in part the significant loss of financial sector-related revenue in recent years, there is a considerable scope to broaden the tax base. The authorities' plan to replace the single-stage import tax (Monofase) with a value-added tax (VAT) in 2020 would remove distortions and could yield additional revenue provided that rates are sufficiently high, exemptions are limited, and the implementation timeline is consistent with the tax administration capacity (Box 3). Other revenue measures, such as rationalizing wasteful tax rebates (e.g. on petroleum), broadening excise taxation, and maintaining some elements of the wealth tax would also help increase revenue.

Tax Revenue, 2017
(Percent of GDP)



Sources: Eurostat and IMF staff.

- **Expenditure**. Significant savings could be achieved by pension reforms that would allow containing transfers to the ISS (see Annex VI). Implementing key elements of the proposed reform, including the postponement of retirement age and transitioning into a defined-contribution system, would help safeguard the pension system sustainability and achieve budget savings. The authorities' efforts to develop a wealth indicator for households could facilitate a better-targeting of social benefits, hence strengthen the ISS financial standing. Improving spending efficiency across government units by conducting comprehensive spending reviews would allow shifting resources towards growth-enhancing spending.

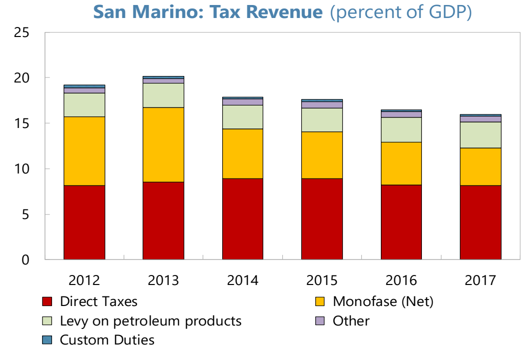
[6] See San Marino's 2018 Selected Issues.

26. Additional PFM reforms would help support the fiscal adjustment. Priority should be given to reforming budget formulation, strengthening macro-fiscal planning, and enhancing fiscal reporting and transparency. Setting up a Treasury department within the Ministry of Finance will help improve debt management capacity and diversify the sovereign financing sources.

Box 3. VAT Implementation in San Marino

The authorities plan to introduce a VAT in 2020. While the modalities are still under consideration, the VAT is planned to replace the current main indirect tax, the *Monofase*, which is a single-stage import tax levied on goods and related services (e.g. transport and insurance) refunded on exports. The *Monofase* has a relatively narrow base and represents 53 percent of all indirect taxes with a collection of 4.2 percent of GDP in 2017. The draft law is scheduled to be presented to Parliament in the first half of 2019 and has been developed in close discussion with the Italian authorities with a view to avoiding double-taxation and no taxation.

San Marino: Tax Revenue (percent of GDP)



Source: Sammarinese authorities.

Benefits: Adoption of the VAT will serve multiple purposes. First, it will increase economic efficiency by shifting taxation toward final consumption rather than inputs of production as is currently the case with *Monofase*. Second, the VAT will enhance San Marino's economic integration with its main trading partners, allowing businesses to share the same system of taxation. Lastly, the VAT—if implemented correctly—could play an important role in broadening the tax base and mobilize revenue in the medium term. According to the authorities' projections, the VAT would increase revenue collection by up to one percent of GDP compared to the *Monofase*.

Implementation challenges: The VAT presents opportunities but also some specific challenges for San Marino. International experience suggests that VAT is an important source of revenues for microstates. However, the absence of border controls and the fact that the customs authorities are outside the country (in Italy) can increase the risk of non-compliance. A successful implementation of the VAT in San Marino would require adoption of a modern and simple VAT system with sufficiently high rates and limited exemptions to avoid revenue losses and negative economic effects. Addressing tax administration capacity issues is critical to ensure a successful VAT adoption. This requires setting out a comprehensive implementation plan, restructuring and re-training the Tax Office workforce, and upgrading its IT system. Other key elements for a successful adoption include a sound VAT refund system, an efficient exchange of information with Italy on cross-border matters, and mitigation of tax avoidance and evasion. Two IMF technical assistance missions (May and November 2018) guided the authorities on implementation issues.

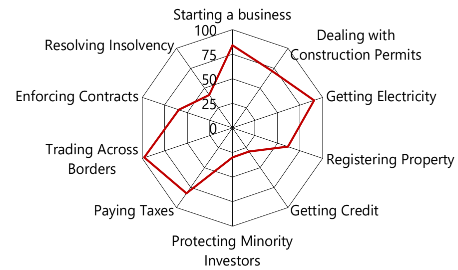
Authorities' Views

27. The authorities recognized the fiscal risks related to banking system repair and concurred that fiscal reforms are needed to ensure debt sustainability. They acknowledged that the government's transfers to CRSM could have an adverse impact on the 2019 fiscal balance but stressed their intention to introduce further measures during the year to contain the deficit, after CRSM financial statement is approved. The authorities noted the challenging political environment and the need to achieve broad agreement with social partners to ensure a successful implementation of indirect taxation and pension reforms. The authorities emphasized that the budget law prohibits the conversion of tax credits into government bond. They also underlined that domestic resources for banking system repair are insufficient and noted their intention to seek external financing.

C. Promoting a Sustained Economic Growth

28. Sustained efforts are needed to improve the business environment. Notwithstanding the welcome improvement in San Marino's Doing Business score in recent years, the economy still performs poorly in several indicators, suggesting that there is scope to reduce structural impediments to better attract foreign investment and improve external competitiveness. Priority should be given to further reducing red tape, streamlining the judicial processes, improving corporate governance, and enhancing creditors and borrowers' rights.

Doing Business Score, Distance from the Frontier
(0-100, where 100 is the frontier)



Sources: World Bank, Doing Business.

29. Strengthening labor supply further will support higher productivity and enhance growth prospects. The recent "Development Law", which eased the process for hiring nonresidents, has shown results. Yet, further relaxation, including by removing the surcharge on hiring nonresidents while expanding the range of residency permits to foreign workers would help reduce the skill mismatches, alleviate capacity constraints, and increase productivity. The recently established Office for Active Labor Market Policies could support higher employment and growth by more targeted social benefits as well as enhanced training and job search.

30. Increasing economic integration and addressing infrastructure gaps would increase competitiveness and help expand market access. The newly-established Economic Development Agency is expected to help expand market access for domestic firms, attract tourists, and promote higher foreign direct investments, while a conclusion of the Association Agreement with the EU would bring further benefits, including by simplifying the operations of Sammarinese firms abroad. These efforts should be complemented by higher investment in telecommunication and transportation to improve business connectivity with trading partners.

Authorities' Views

31. The authorities reiterated their commitments to tackle structural impediments. They noted that further integration with Italy and EU would provide domestic companies better opportunities to expand and operate abroad and emphasized that improving infrastructure in telecommunication, for which important investment have already been made, and transportation will help increase connectivity and promote higher growth. Given the tight budget constraints, the authorities favored facilitating higher private investment, including in innovative sectors, by subsidizing firms' loan interest payments, expanding tax incentives, reducing red tape, and utilizing public-private partnerships. The authorities emphasized the untapped potential in the tourism sector and underlined their plans to boost hotels' capacity and develop skills in this sector.

DATA

32. Progress has been made in enhancing data provision but more needs to be done. The authorities started using the standardized Report Forms to publish the IMF Monetary and Financial Statistics in 2018, and with the support of IMF technical assistance, produced balance of payment statistics for 2017 and international investment position for 2016–17. While data provision is broadly adequate for surveillance, data gaps, including in the balance of payment and external debt components, exist, requiring further efforts to improve the quality, frequency, and reporting of relevant statistics such that businesses and policymakers could better assess the state of the economy and make informed decisions.

STAFF APPRAISAL

33. San Marino's growth prospects are weighed down by legacy problems and downside risks. Past failures and deep-rooted weaknesses in the banking system have dampened credit conditions, undermined economic activity, and are now threatening financial stability and fiscal sustainability. Real GDP growth is set to remain subdued over the near and medium term on the back of continued banking system deleveraging and less favorable external conditions while elevated financial and fiscal fragilities pose significant downside risks. The external position is weaker than implied by fundamentals and desirable policy settings.

34. A significant policy adjustment is urgently needed to shift San Marino to a sustainable path of growth and prosperity. Restoring credit supply, stabilizing the banking system, and mitigating fiscal risks would require immediate implementation of a comprehensive strategy that will consist of banking system restructuring, an ambitious and growth-friendly fiscal consolidation, and structural reforms to boost competitiveness and bolster growth. A full commitment of all stakeholders in San Marino is critical for a successful implementation of this strategy.

35. Safeguarding CBSM liquidity buffers should be a priority. The CBSM reserves should be brought to adequate levels, including by aligning the ELA framework with best practice and restricting CBSM budget financing to only exceptional needs and on a temporary basis. Well-developed measures and a carefully-crafted communication strategy are crucial to respond to a potential resurgence in liquidity pressures and to safeguard the payment system.

36. Rapid progress on banking system restructuring is critical to restore viability. Upfront loss recognition and recapitalization are needed to improve confidence, restore financial intermediation, and increase banks' resilience to shocks. Systemically-important and viable banks should benefit from state support to the extent feasible following burden sharing, while other undercapitalized banks that fail to raise fresh capital from private sources should be subject to corrective action. Converting tax credits held by banks into government bonds and significantly reducing banks' operating costs are needed to support viability and capacity to build capital through internal means. High NPL levels need to be reduced to safe levels over the medium term through intensive supervisory oversight of NPL reduction targets as well as measures to remove tax, legal, and regulatory impediments.

37. Steps to strengthen financial sector oversight and further reduce risks would help safeguard financial stability. Enhancing the CBSM's intervention powers and tools would substantially improve financial safety nets while strengthening supervisory capacity would ensure effective risk monitoring and timely interventions in failing banks. A review of the Central Bank law is needed to enhance its independence, governance, and accountability. Sustained efforts to contain financial integrity risks, including in the context of the ongoing preparation of the second National Risk Assessment are welcome.

38. Putting public debt on a sustainable path and gradually building fiscal buffers require a broader fiscal strategy. Limiting the state's contribution to bank recapitalization and adoption of a credible fiscal adjustment, which relies on indirect tax and pension reforms, rationalization of wasteful tax rebates, and improvement of spending efficiency, are needed to safeguard public finances and build adequate fiscal buffers. Strengthening debt management capacity and diversifying the sovereign financing sources are also critical to reduce fiscal risks.

39. Addressing structural weaknesses and expanding market access are important to promote higher growth. Policies should focus on strengthening the labor supply, including by further relaxing hiring restrictions of nonresidents, better targeting social benefits, and delaying the retirement age. Further improvements in the business climate, increasing economic integration and closing the infrastructure gaps, particularly in transportation and telecommunication, would boost foreign investment and medium-term growth.

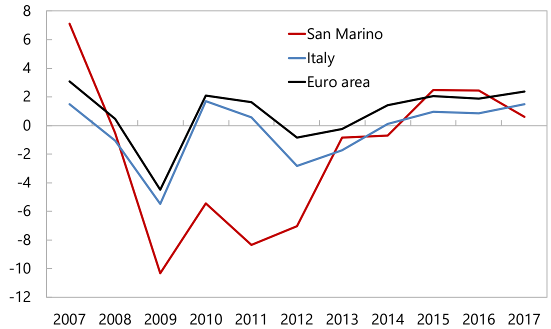
40. Efforts to improve data provision need to be sustained. San Marino has made a welcome progress in improving data provision and reporting. Ensuring that sufficient resources are allocated to the Statistical Office and the CBSM would help close the remaining data gaps and improve the frequency, coverage, and reporting of relevant statistics, thus allowing businesses and policymakers to make informed decisions.

41. Staff propose that the next Article IV consultation with the Republic of San Marino follows the standard 12-month cycle.

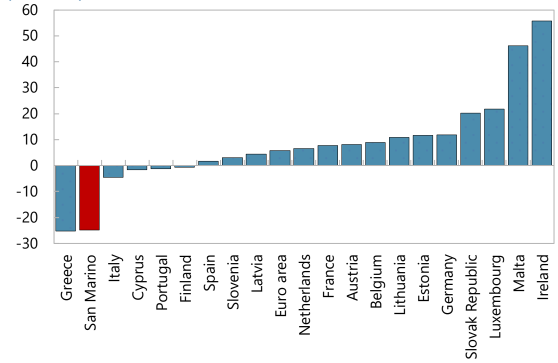
Figure 1. San Marino: Macroeconomic Developments

Economic activity has recovered from a prolonged recession… *…yet real GDP remains well below its pre-crisis levels.*

Real GDP Growth
(Percent)

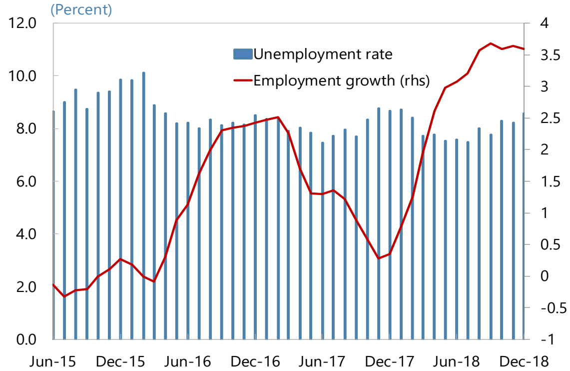


Cumulative Real GDP Growth, 2008-17
(Percent)

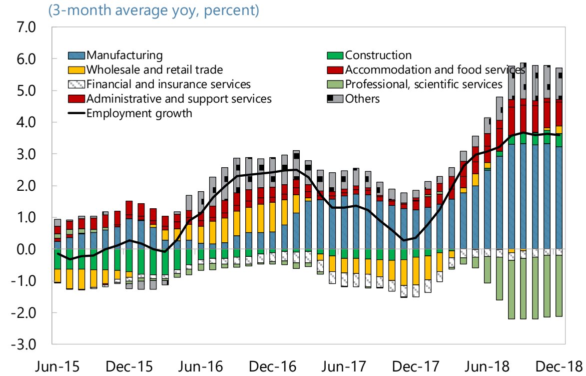


Employment growth picked up, but unemployment slightly increased after moderating in early 2018. *Strong job creation was registered in manufacturing and tourism-related activities.*

Labor Markets
(Percent)

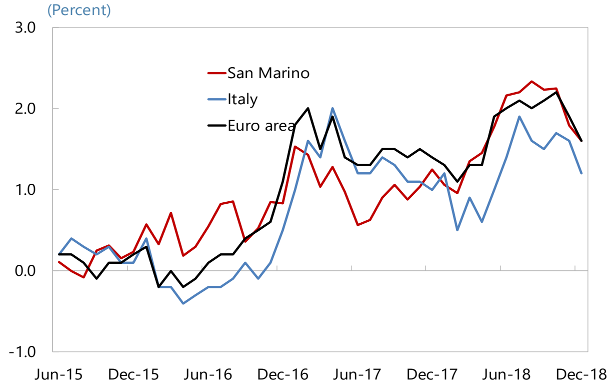


Sectoral Contributions to Private Employment Growth
(3-month average yoy, percent)

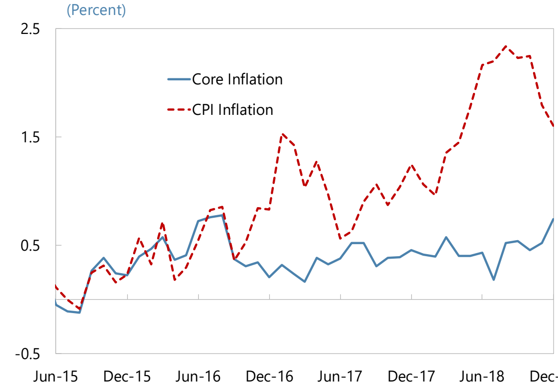


Inflation decelerated recently in line with that in key trading partners… *…but core inflation has remained broadly stable.*

CPI Inflation
(Percent)



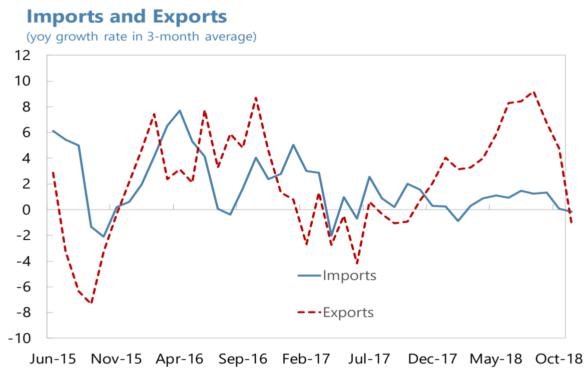
CPI and Core Inflation
(Percent)



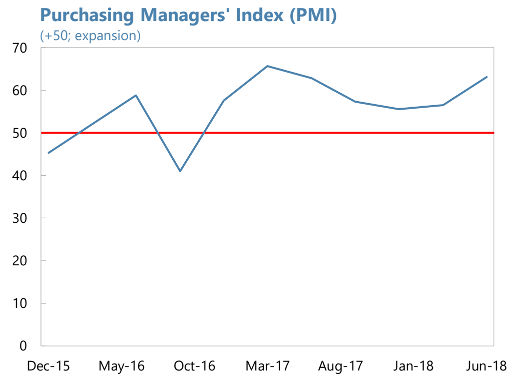
Source: World Economic Outlook, UPECEDS, and IMF staff.

Figure 2. San Marino: High Frequency Indicators

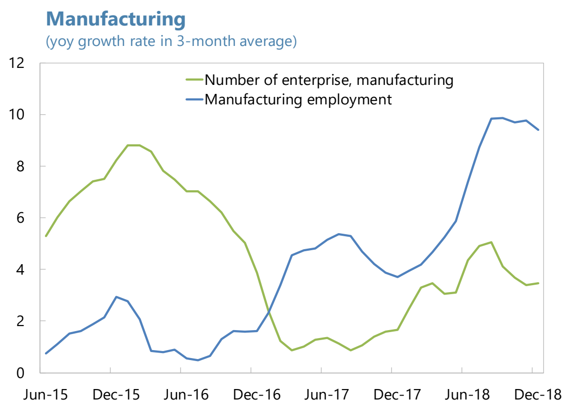
Exports increased, driven by improved external conditions, but sharply moderated in late 2018.



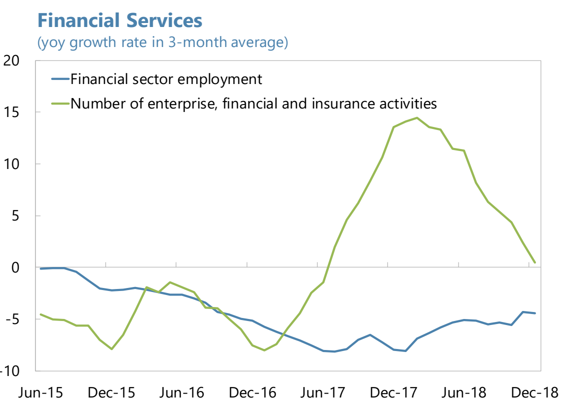
The PMI shows expansion in manufacturing activity up to the second quarter.



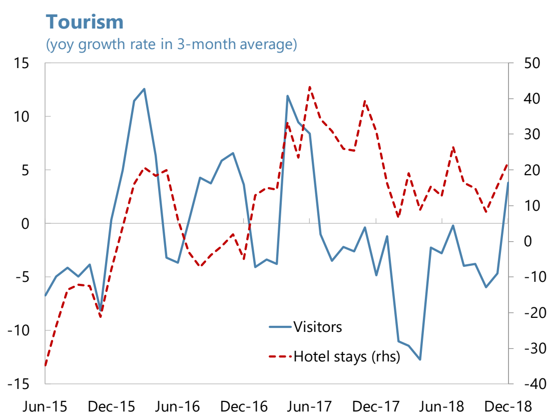
Job creation and the number of firms in manufacturing increased during 2018…



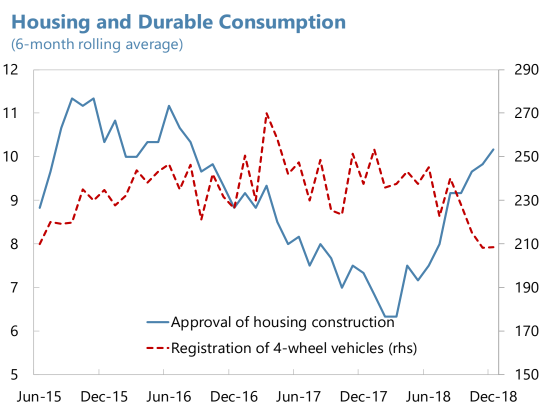
…against continued downsizing in the financial sector.



Tourism arrivals declined in most 2018, while hotel stays remained broadly unchanged.



Housing construction picked up from low levels while car registration has dropped.

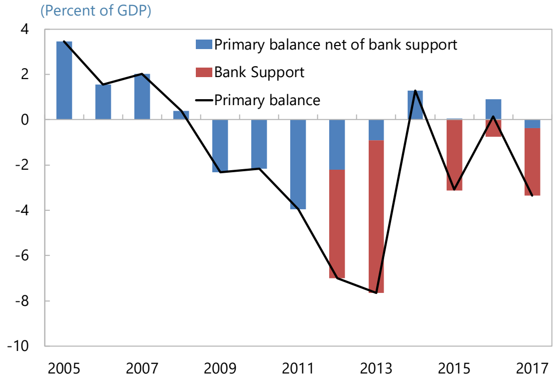


Source: Central Bank of San Marino and IMF staff.

Figure 3. San Marino: Fiscal Developments

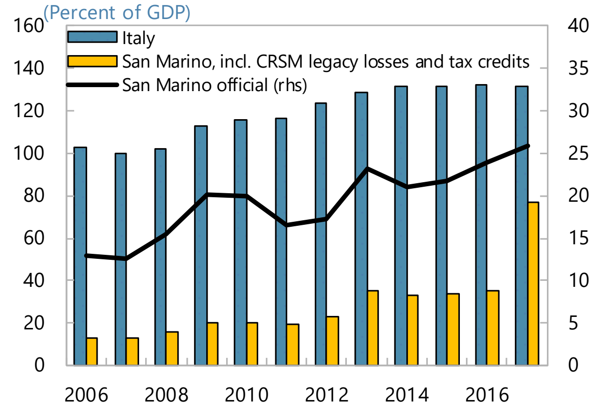
Public interventions in the banking sector contributed to a deterioration of the primary fiscal balance.

Primary Fiscal Balance
(Percent of GDP)



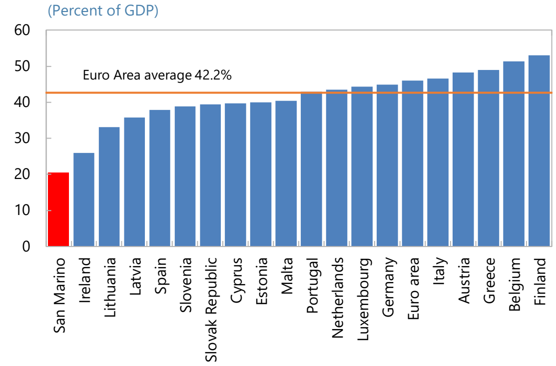
Excessive state's commitments to the banking system resulted in a significant increase in public debt in 2017.

Government Debt
(Percent of GDP)



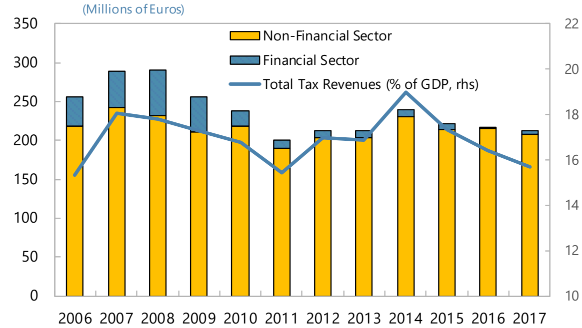
Government revenues are below euro area average…

Government Revenue, 2017
(Percent of GDP)



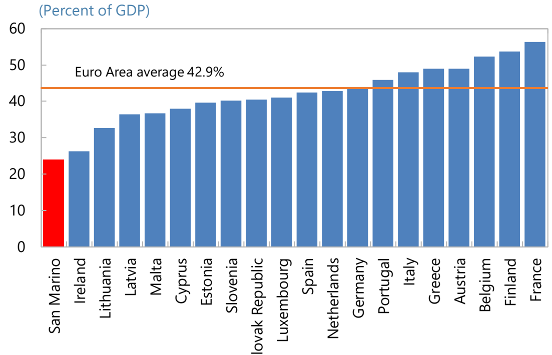
…while tax revenue losses from the financial sector have been significant.

Tax Revenues
(Millions of Euros)



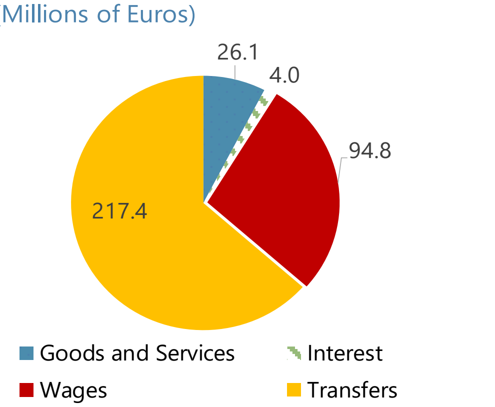
While the size of government is small…

Government Expenditure, 2017
(Percent of GDP)



… spending is rigid, and mostly on social transfers and wages.

Composition of Current Expenditure, 2017
(Millions of Euros)

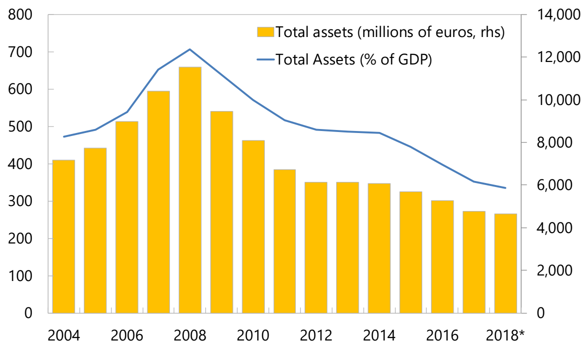


Source: Eurostat, Sammarinese authorities, and IMF staff.

Figure 4. San Marino: Financial Sector

Downsizing of the Sammarinese banking sector has continued since the global financial crisis….

Banking System Assets

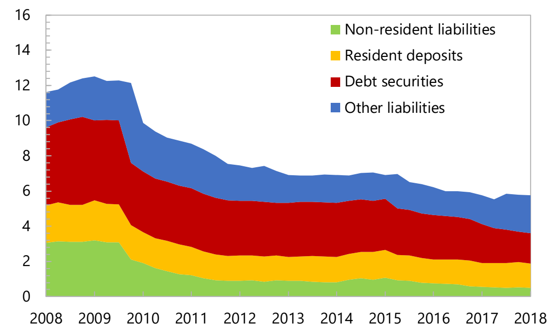


*As of November 2018.

…due to outflows of deposits and certificates of deposit, largely by non-residents.

Banking System Funding

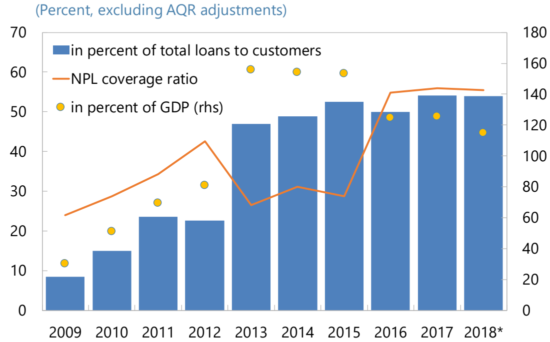
(Billions of euros)



NPLs continue to be high and the loan provision coverage remains low.

Banking Sector's Non-Performing Loans

(Percent, excluding AQR adjustments)

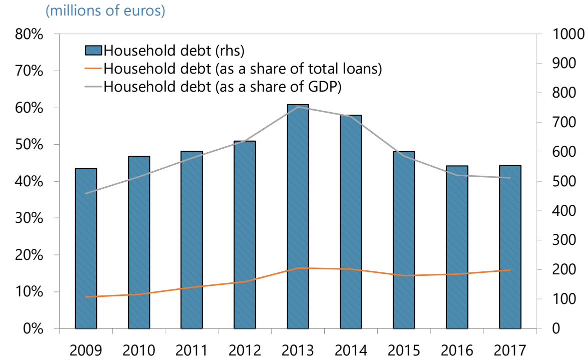


*As of November 2018.

Households continued to deleverage, albeit at a slower pace.

Household debt

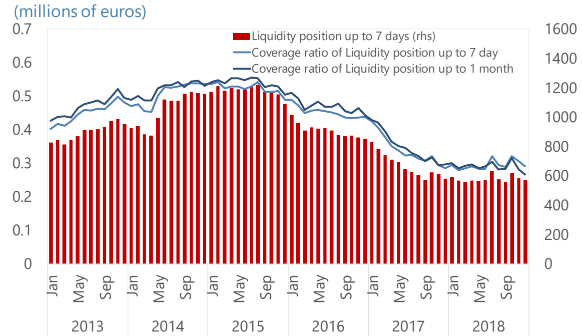
(millions of euros)



Liquidity situation deteriorated since 2015 due to deepening banking sector fragilities.

Banking Sector Liquidity

(millions of euros)

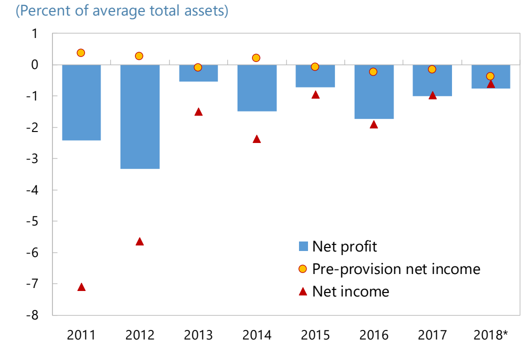


Note: Coverage ratios are liquid position (liquid assets plus net interbank loans up to 7 days/1 month) as a share of customer deposits and financial instruments up to 7 days/1 month.

Banks continue to report losses, reflecting high operational cost and a high share of assets that do not generate income.

Banking Sector's Profitability

(Percent of average total assets)



*As of November 2018.

Source: Central Bank of San Marino and IMF staff.

Table 1. San Marino: Selected Economic and Social Indicators, 2016–24

GDP per capita (2016): 45,670 U.S. dollars | Life expectancy at birth (2017): 84.7 years
Population (2017): 33,328 persons | Literacy, adult (2015): 96 percent

		Prel.	Projection						
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Activity and Prices									
Real GDP (percent change)	2.5	0.6	1.1	0.8	0.7	0.6	0.5	0.5	0.5
Domestic demand	4.5	3.4	-0.2	0.6	0.7	0.6	0.6	0.6	0.6
Final consumption	-0.6	-0.9	-0.8	-0.7	0.0	0.0	0.1	0.1	0.1
Fixed investment	13.5	9.0	11.6	3.5	2.1	1.7	1.7	1.7	1.7
Net exports	-0.8	-2.0	1.3	0.4	0.2	0.2	0.1	0.1	0.0
Exports	2.0	-1.1	2.8	2.0	1.7	1.6	1.6	1.6	1.6
Imports	2.9	0.0	2.4	2.1	1.8	1.7	1.8	1.8	1.8
Contribution to GDP	2.5	0.6	1.1	0.8	0.7	0.6	0.5	0.5	0.5
Domestic demand	2.2	1.4	2.2	0.4	0.5	0.4	0.4	0.4	0.5
Final consumption	-0.3	-0.5	-0.5	-0.4	0.0	0.0	0.0	0.0	0.0
Fixed investment	2.6	1.9	2.6	0.8	0.5	0.4	0.4	0.4	0.4
Inventories	1.0	1.0	-2.4	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	-0.8	-1.8	1.4	0.4	0.2	0.2	0.1	0.1	0.0
Employment (percent change)	1.0	1.1	2.4	1.2	0.5	0.3	0.3	0.3	0.3
Unemployment rate (average; percent)	8.6	8.1	8.0	8.1	8.1	8.1	8.1	8.1	8.1
Inflation rate (average; percent)	0.6	1.0	1.6	1.6	1.7	1.7	1.8	1.8	1.8
Nominal GDP (millions of euros)	1326.5	1353.1	1386.7	1416.4	1446.7	1476.7	1506.7	1537.6	1569.2
Public Finances (percent of GDP) 1/									
Revenues	23.3	22.1	22.9	20.9	20.9	20.6	20.7	20.7	20.6
Expenditure	23.4	25.7	25.7	23.3	24.0	23.9	23.7	23.6	23.5
Overall balance	-0.2	-3.6	-2.7	-2.4	-3.0	-3.2	-3.0	-2.9	-2.9
Government debt (official)	24.0	25.9	27.5	28.8	31.0	33.6	36.0	38.3	40.6
Government debt (incl. CRSM legacy losses and tax credits)	35.2	76.6	77.0	77.1	77.9	78.0	78.1	78.2	78.3
Money and Credit 2/									
Deposits (percent change)	-5.6	-12.3	-1.5	…	…	…	…	…	…
Private sector credit (percent change)	-5.1	1.1	-2.9	…	…	…	…	…	…
Net foreign assets (percent of GDP)	161.1	138.1	133.0	…	…	…	…	…	…
Commercial banks	130.8	117.8	109.7	…	…	…	…	…	…
Central bank	30.2	20.3	23.3	…	…	…	…	…	…
External Accounts (percent of GDP)									
Current Account	…	-0.5	0.4	0.4	0.2	0.1	0.1	0.1	0.2
Exports	…	159.4	160.0	160.9	161.3	161.7	162.4	163.1	163.8
Imports	…	152.1	152.4	153.7	154.6	155.2	155.9	156.5	157.1
Gross international reserves (millions of euros)	427.8	252.7	252.5	…	…	…	…	…	…
Financial Soundness Indicators (percent) 3/									
Regulatory capital to risk-weighted assets	11.5	13.7	13.8	…	…	…	…	…	…
NPL ratio 4/	50.0	54.0	53.0	…	…	…	…	…	…
NPL coverage ratio 4/	54.8	56.0	55.8	…	…	…	…	…	…
Return on equity (ROE)	-13.2	-10.0	-8.3	…	…	…	…	…	…
Liquid assets to total assets	28.0	22.7	22.3	…	…	…	…	…	…
Liquid assets to short-term liabilities	53.0	40.6	40.7	…	…	…	…	…	…

Sources: International Financial Statistics; IMF Financial Soundness Indicators; Sammarinese authorities; World Bank; and IMF staff.
1/ For the central government.
2/ 2018 data are as of September 2018 for Deposits and as of August 2018 for the others.
3/ 2017-18 data do not reflect 2017 AQR results. 2018 data are as of September 2018.
4/ CBSM supervisory data. Supervisory data reflect retrospective revisions made by banks in closing their annual financial statements and loans to banks are excluded.

Table 2a. San Marino: Statement of Operations for Budgetary Central Government, 2016–24

(Millions of euros)

		Est.				Proj.			
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue	308.4	298.6	318.1	295.6	302.7	304.8	312.0	318.4	323.8
Taxes	217.4	212.6	232.7	229.3	235.0	235.7	241.5	246.5	250.4
Income Taxes	109.1	110.1	112.8	116.3	118.7	116.1	118.5	120.9	123.4
Non-income taxes	108.3	102.4	119.9	113.0	116.3	119.6	123.0	125.6	127.0
Taxes on international trade	73.0	66.3	69.0	71.4	73.8	76.2	78.8	80.4	80.9
Other taxes	35.3	36.1	50.8	41.6	42.5	43.4	44.3	45.2	46.1
Non-tax revenue	91.0	86.1	85.3	66.3	67.7	69.1	70.5	71.9	73.4
Expenditure	310.9	347.7	356.0	330.0	345.9	351.9	357.9	364.2	370.6
Current Expenditure	308.9	345.5	352.4	326.0	341.4	347.3	353.2	359.5	365.8
Compensation of employees	92.8	94.8	96.1	94.8	96.8	98.9	100.9	102.9	105.0
Use of goods and services	28.2	26.1	26.5	25.0	25.6	26.1	26.6	27.2	27.7
Interest	4.4	4.0	5.4	6.3	7.2	8.9	10.6	12.3	14.0
Transfers	180.2	217.4	219.7	195.5	207.4	209.1	210.7	212.5	214.3
To other general government units	159.7	148.7	155.6	140.5	154.4	157.6	160.8	164.1	167.5
To the banking sector	10.0	40.0	44.1	33.5	31.5	29.5	27.5	25.5	23.5
To other private sector entities	10.4	28.8	20.0	21.5	21.5	22.0	22.4	22.9	23.3
Other expenses (including subsidies)	3.4	3.2	4.6	4.4	4.4	4.4	4.5	4.6	4.7
Net acquisition of non-financial assets	2.0	2.2	3.6	4.0	4.5	4.5	4.6	4.7	4.8
Overall Balance	-2.5	-49.1	-37.9	-34.4	-43.2	-47.1	-45.9	-45.8	-46.8
Memorandum items									
Pension Funds Balance (net of gov. transfers)	-32.7	-35.9	…	…	…	…	…	…	…
Primary Balance	1.9	-45.1	-32.5	-28.1	-36.0	-38.2	-35.3	-33.5	-32.8
Primary Balance net of bank support	11.9	-5.1	11.6	5.4	-4.5	-8.7	-7.8	-8.0	-9.3
Public debt (official)	318.2	351.1	381.9	408.4	448.8	496.1	542.6	589.4	637.8
Public debt (incl. tax credits and CRSM legacy losses)	467.5	1037.1	1067.9	1092.4	1126.3	1152.2	1176.9	1201.9	1228.7
Nominal GDP (in millions of euros)	1326.5	1353.1	1386.7	1416.4	1446.7	1476.7	1506.7	1537.6	1569.2

Sources: Sammarinese authorities; and IMF staff.

Table 2b. San Marino: Statement of Operations for Budgetary Central Government, 2016–24

(Percent of GDP)

		Est.				Proj.			
	2016	2017	2018	2019	2020	2021	2022	2023	2024
Revenue	23.3	22.1	22.9	20.9	20.9	20.6	20.7	20.7	20.6
Taxes	16.4	15.7	16.8	16.2	16.2	16.0	16.0	16.0	16.0
Income Taxes	8.2	8.1	8.1	8.2	8.2	7.9	7.9	7.9	7.9
Non-income taxes	8.2	7.6	8.6	8.0	8.0	8.1	8.2	8.2	8.1
Taxes on international trade and transactions	5.5	4.9	5.0	5.0	5.1	5.2	5.2	5.2	5.2
Other taxes	2.7	2.7	3.7	2.9	2.9	2.9	2.9	2.9	2.9
Non-tax revenue	6.9	6.4	6.2	4.7	4.7	4.7	4.7	4.7	4.7
Expenditure	23.4	25.7	25.7	23.3	23.9	23.8	23.8	23.7	23.6
Current Expenditure	23.3	25.5	25.4	23.0	23.6	23.5	23.4	23.4	23.3
Compensation of employees	7.0	7.0	6.9	6.7	6.7	6.7	6.7	6.7	6.7
Use of goods and services	2.1	1.9	1.9	1.8	1.8	1.8	1.8	1.8	1.8
Interest	0.3	0.3	0.4	0.4	0.5	0.6	0.7	0.8	0.9
Transfers	13.6	16.1	15.8	13.8	14.3	14.2	14.0	13.8	13.7
To other general government units	12.0	11.0	11.2	9.9	10.7	10.7	10.7	10.7	10.7
To the banking sector	0.8	3.0	3.2	2.4	2.2	2.0	1.8	1.7	1.5
To other private sector entities	0.8	2.1	1.4	1.5	1.5	1.5	1.5	1.5	1.5
Other expenses (including subsidies)	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Net acquisition of non-financial assets	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Overall Balance	-0.2	-3.6	-2.7	-2.4	-3.0	-3.2	-3.0	-3.0	-3.0
Memorandum items									
Pension Funds Balance (net of gov. transfers)	-2.5	-2.7	…	…	…	…	…	…	…
Primary Balance	0.1	-3.3	-2.3	-2.0	-2.5	-2.6	-2.3	-2.2	-2.1
Primary Balance net of bank support	0.9	-0.4	0.8	0.4	-0.3	-0.6	-0.5	-0.5	-0.6
Public debt (official)	24.0	25.9	27.5	28.8	31.0	33.6	36.0	38.3	40.6
Public debt (incl. tax credits and CRSM legacy losses)	35.2	76.6	77.0	77.1	77.9	78.0	78.1	78.2	78.3
Nominal GDP (in millions of euros)	1326.5	1353.1	1386.7	1416.4	1446.7	1476.7	1506.7	1537.6	1569.2

Sources: Sammarinese authorities; and IMF staff.

Table 3. San Marino: Balance of Payments, 2017–24

(Millions of euros)

	2017	2018	2019	2020	2021	2022	2023	2024
	Est.				Projections			
Current account balance	-6.9	5.5	5.3	2.7	1.9	1.5	1.6	3.6
Balance of goods and services	99.2	105.1	101.3	97.0	96.3	97.8	101.7	104.4
Goods balance	115.5	121.0	119.6	117.6	118.3	120.6	124.6	127.8
Exports	1,579.6	1,624.7	1,668.8	1,708.7	1,749.2	1,792.4	1,836.9	1,882.5
Imports	1,464.1	1,503.7	1,549.2	1,591.0	1,630.9	1,671.8	1,712.2	1,754.6
Services balance	-16.3	-15.9	-18.2	-20.6	-22.0	-22.8	-22.9	-23.5
Exports	577.2	593.7	609.8	624.4	639.2	655.0	671.2	687.9
Imports	593.5	609.6	628.1	645.0	661.2	677.7	694.1	711.3
Primary income balance	-91.1	-85.4	-81.4	-79.2	-78.9	-80.4	-83.7	-84.3
Credit	104.4	104.1	104.0	103.9	103.7	103.6	103.5	103.3
Debit	195.5	189.5	185.3	183.1	182.6	184.0	187.1	187.6
Secondary income balance	-15.1	-14.2	-14.7	-15.1	-15.5	-16.0	-16.4	-16.5
Capital account balance	3.1	3.0	3.0	3.1	3.1	3.2	3.3	3.3
Financial account balance	-38.0	47.2	8.1	5.6	4.8	4.4	4.6	6.6
Direct investments	-26.6	8.4	6.4	7.0	7.0	7.7	6.5	7.0
Portfolio investments	-6.4	17.5	8.4	8.4	7.3	6.3	8.7	9.4
Other investments	121.4	27.2	13.3	10.2	10.4	10.4	9.4	10.2
Change in reserve assets (increase = +)	-126.5	-6.0	-20.0	-20.0	-20.0	-20.0	-20.0	-20.0
Net errors and omisions	-34.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
				(In percent of GDP)				
Current account balance	-0.5	0.4	0.4	0.2	0.1	0.1	0.1	0.2
Balance of goods and services	7.3	7.6	7.2	6.7	6.5	6.5	6.6	6.8
Goods balance	8.5	8.7	8.4	8.1	8.0	8.0	8.1	8.3
Exports	116.7	117.2	117.8	118.1	118.4	119.0	119.5	121.8
Imports	108.2	108.4	109.4	110.0	110.4	111.0	111.4	113.5
Services balance	-1.2	-1.1	-1.3	-1.4	-1.5	-1.5	-1.5	-1.5
Exports	42.7	42.8	43.1	43.2	43.3	43.5	43.7	44.5
Imports	43.9	44.0	44.3	44.6	44.8	45.0	45.1	46.0
Income balance	-6.7	-6.2	-5.7	-5.5	-5.3	-5.3	-5.4	-5.5
Credit	7.7	7.5	7.3	7.2	7.0	6.9	6.7	6.7
Debit	14.5	13.7	13.1	12.7	12.4	12.2	12.2	12.1
Secondary income balance	-1.1	-1.0	-1.0	-1.0	-1.1	-1.1	-1.1	-1.1
Capital account balance	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account balance	-2.8	3.4	0.6	0.4	0.3	0.3	0.3	0.4
Direct investments	-2.0	0.6	0.5	0.5	0.5	0.5	0.4	0.5
Portfolio investments	-0.5	1.3	0.6	0.6	0.5	0.4	0.6	0.6
Other investments	9.0	2.0	0.9	0.7	0.7	0.7	0.6	0.7
Change in reserve assets (increase = +)	-9.3	-0.4	-1.4	-1.4	-1.4	-1.3	-1.3	-1.3
Net errors and omisions	-2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items								
Nominal GDP (in millions of euros)	1,353.1	1,386.7	1,416.4	1,446.7	1,476.7	1,506.7	1,537.6	1,545.3
GIR (in millions of euros)[1/]	258.5	252.5	232.5	212.5	192.5	172.5	152.5	132.5
GIR in months of imports	1.5	1.4	1.3	1.1	1.0	0.9	0.8	0.6

Sources: San Marino Statistical Office and IMF staff.

1/ Preliminary estimates for 2017 and 2018.

Table 4. San Marino: Depository Corporate Survey, 2012–18 1/

	2012	2013	2014	2015	2016	2017	2018. Aug
			(In Millions of euros, end of period)				
Net foreign assets	2600.1	2643.5	2512.2	2340.4	2136.5	1868.3	1844.5
Claims on nonresidents	3938.9	3864.1	3801.2	3433.9	3054.8	2612.8	2544.3
Central Bank	267.5	367.7	298.0	321.5	401.2	274.7	322.8
Other Depository Corporations	3671.4	3496.4	3503.2	3112.4	2653.7	2338.1	2221.4
Liabilities to Nonresidents	-1338.8	-1220.6	-1288.9	-1093.5	-918.4	-744.4	-699.7
Central Bank	0.0	0.0	0.0	0.0	-0.1	-0.2	-0.2
Other Depository Corporations	-1338.8	-1220.6	-1288.9	-1093.5	-918.2	-744.2	-699.5
Net domestic assets	1455.0	1557.5	1693.7	1323.4	1382.5	1122.4	1068.6
Net Claims on Central Government	200.9	229.4	202.9	-8.8	-35.1	-234.8	-257.4
Claims on State and Local Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on Public Nonfinancial Corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on NBFIs	799.7	690.7	625.9	485.0	381.6	263.0	266.6
Claims on private sector	1506.3	1535.2	1656.2	1547.1	1468.6	1485.3	1442.0
Corporates	965.5	980.0	898.7	945.3	914.2	925.9	900.3
Households	540.8	555.1	757.5	601.8	554.3	559.4	541.7
Capital and Reserves	590.4	599.6	544.7	519.7	471.5	419.8	432.1
Other items, net	461.5	298.2	246.7	180.3	-39.0	-28.7	-49.5
Broad Money	1472.8	1539.1	1635.1	1430.0	1466.7	1441.6	1424.2
Currency in Circulation	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transferable Deposits	1334.7	1385.8	1449.7	1340.5	1372.2	1370.5	1363.5
Other Deposits	138.2	153.4	185.4	89.4	94.5	71.1	60.7
Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term securities excluded from Broad Money	2582.2	2661.8	2570.8	2233.8	2052.3	1549.1	1489.0
			(Annual percentage change)				
Net foreign assets	-18.4	1.7	-5.0	-6.8	-8.7	-12.6	-1.3
Net domestic assets	42.2	7.0	8.7	-21.9	4.5	-18.8	-4.8
Claims on private sector	-2.2	1.9	7.9	-6.6	-5.1	1.1	-2.9
Corporates	-7.4	1.5	-8.3	5.2	-3.3	1.3	-2.8
Households	8.7	2.6	36.4	-20.5	-7.9	0.9	-3.2
Broad Money	-0.1	4.5	6.2	-12.5	2.6	-1.7	-1.2

Sources: International Financial Statistics and IMF Staff.

1/ Data beginning in June 2015 accord to the IMF's monetary and financial statistics methodology, and are not strictly comparable to earlier periods.

Table 5. San Marino: Financial Soundness Indicators, 2012–18

	2012	2013	2014	2015	2016	2017	2018.Sept
Capital adequacy ratios (percent) 1/							
Regulatory capital to risk-weighted assets	8.8	13.6	11.4	12.7	11.5	13.7	13.8
Capital to assets	6.3	7.3	6.2	6.9	6.2	6.5	7.0
Asset quality ratios (percent) 1/ 2/							
Bad loans to total loans	10.6	15.4	18.2	20.8	18.3	20.5	19.3
Nonperforming loans to total loans	22.6	47.0	48.8	52.6	50.0	54.0	53.0
Bad loans net of provision to capital	58.7	54.6	70.1	79.6	73.8	78.6	77.7
Nonperforming loans net of provision to capital	164.3	289.3	332.1	340.0	224.4	250.1	234.6
NPL coverage ratio	42.6	26.5	31.1	28.7	54.8	56.0	55.8
Earning and profitability (percent)							
Return on assets (ROA)	-2.2	-0.6	-1.8	-0.7	-1.0	-0.7	-0.6
Return on equity (ROE)	-22.5	-7.8	-21.4	-9.0	-13.2	-10.0	-8.3
Interest margin to gross income	58.5	46.1	32.1	37.3	39.0	42.4	49.3
Non-interest expenses to gross income	69.7	81.2	50.7	60.7	70.4	65.1	70.4
Trading income to gross income	11.7	13.3	13.9	1.9	3.0	4.1	-12.5
Personnel expenses to non-interest expenditures	55.7	59.5	61.7	62.5	63.2	58.6	61.3
Liquidity (percent)							
Liquid assets to total assets	28.0	29.6	32.4	29.8	28.0	22.7	22.3
Liquid assets to short-term liabilities	58.7	60.6	65.4	58.9	53.0	40.6	40.7
Loans to deposits	91.8	86.7	80.0	81.8	79.6	83.8	82.9
Memo items							
Banking system assets (millions of euros) 2/	6122.1	6141.1	6081.9	5692.0	5279.8	4763.6	4710.3
percent of GDP	490.1	486.0	482.9	444.9	398.0	352.0	339.7

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

1/ 2017-18 data do not reflect 2017 AQR results.

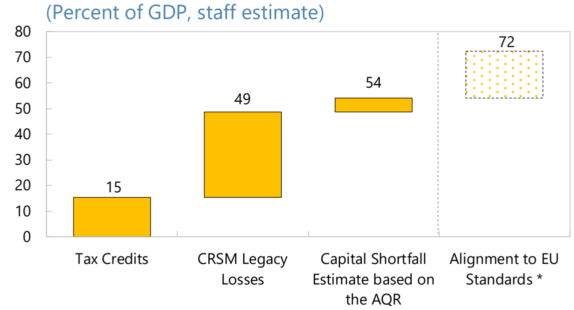
2/ CBSM supervisory data. Supervisory data reflect retrospective revisions made by banks in closing their annual financial statements and loans to banks are excluded.

Annex I. Asset Quality Review and Staff's Estimate of Bank Recapitalization Needs

1. **The CBSM recently updated the Asset Quality Review (2017 AQR update) to reassess banks' asset quality and identify their recapitalization needs.** This exercise updated the 2016 AQR, which was performed by an international consulting firm and used June 2016 data. The 2017 update was carried out by the CBSM with the assistance of another consulting firm. It used June 2017 data and broadly followed the ECB comprehensive assessment methodology for data integrity validation, assessment of loan classifications, collateral valuations, and loan provisions. The update largely relied on the 2016 AQR and did not involve any fresh credit file reviews or independent collateral valuations. The exercise covered six banks, one leasing company, and one closed NPL fund, which comprise about 91 percent of San Marino financial system's assets when CRSM's exposure to Delta and other closed NPL fund assets are excluded. Banks capital requirements and additional provisions were assessed against both international standards (Basel III) and San Marino regulations.[1]

2. **Based on the 2017 AQR update, a capital shortfall in the banking system is estimated to be €540 million (39 percent of GDP) under the application of the San Marino capital requirements, which are materially weaker than international standards.** The capital shortfall at end-2018 is composed of the outstanding CRSM legacy losses (€465 million) and re-estimated capital shortfalls in the banking system based on the 2017 AQR update (€75 million).[2] The application of fully loaded Basel III capital standards would require significantly higher capital levels due to higher provisioning, higher minimum capital requirements and full deduction of deferred tax assets (DTAs)[3]. Yet, even with less stringent requirements under the domestic capital requirements, the identified capital shortfalls are sizable, reflecting a substantial increase in provisioning needs. The exercise resulted in the NPL ratio (excluding the CRSM's exposure to Delta group) increasing to 51 percent from 44 percent, but it would be about 55 percent if the NPLs in the closed funds were included, and even higher if the residual exposure to Delta Group (subsequent to the 2018 sale of Delta Arcade portfolio) was included.

San Marino: Banking System Recapitalization Needs
(Percent of GDP, staff estimate)



* Higher capital levels will be required under the application of the EU standards, which are expected to be transposed in 2019 with a transition period.
Sources: CBSM and IMF staff.

[1] CRSM's exposure to Delta was included in the 2016 AQR, but excluded from the 2017 AQR update since the bank made a significant write down related to Delta exposure in the 2016 financial statements.

[2] Since the 2017 AQR update used June-2017 data, the end-2018 capital shortfall levels are estimated by taking into account the major changes in banks' financials between June-2017 and end-2018.

[3] Additional capital needs under the Basel III standards are estimated as the sum of (i) additional capital shortfalls under the Basel III identified by the 2017 AQR update, (ii) outstanding DTAs at end-2017, and (iii) expected increase in DTAs due to additional losses to be recorded under the application of Base III.

3. Banking system recapitalization should also consider banks' tax credits, amounting to €211 million (15 percent of GDP). Past bank resolutions were funded by the government through providing tax credits to banks that acquired a failed bank as compensation for the excess liabilities over assets of the failed bank. The tax credits do not generate any income, but must be funded, and thus constitute an indirect tax on banks that weighs heavily on their profitability and act as a major deterrent to attracting fresh private investment. Replacing tax credits with interest-bearing assets (e.g. government bonds) would help restore banks' viability and improve attractiveness for private investors.

4. Bank recapitalization should be a key element in the authorities' financial sector strategy. While caution is needed, given that the estimates are based on the 2017 AQR update results, which is becoming outdated with time, the outstanding recapitalization needs—the sum of capital shortfalls and tax credits—are estimated to be €751 million (54 percent of GDP). Private banks should be required to promptly address their capital shortfalls from private sources. Those who fail to meet the capital requirement would need to be subject to corrective action or, if systemically important, receive necessarily restricted state support following agreement on recapitalization and restructuring plan. A strategy to meet additional recapitalization needs to implement Basel III should also be considered carefully.

Annex II. Risk Assessment Matrix[1]

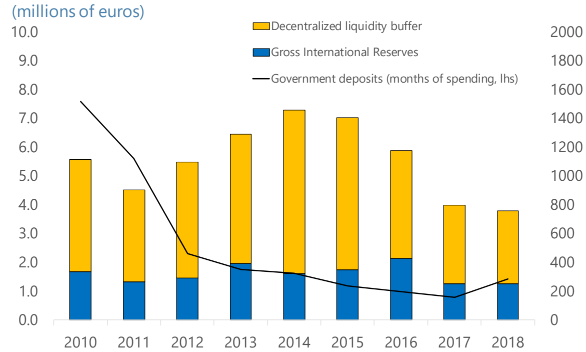
Source of Risks	Impact if Realized	Policy Response
Medium **Weaker-than-expected growth in the euro area.** Progress on fiscal adjustment, on addressing legacy banking-sector problems, and on other structural reforms slows or reverses, raising sustainability concerns, steadily pushing up borrowing costs, and undermining growth prospects.	High With extensive financial and real links with Italy and advanced Europe, the impact on the Sammarinese economy would be large and direct.	• Ease fiscal adjustment and reevaluate periodically; • Address financial sector vulnerabilities; • Proceed with fiscal and structural reforms; and • Further diversify trade and financing options.
High **Sharp tightening of global financial conditions,** which could result in higher debt service and refinancing risks; stress on leveraged firms, households, and vulnerable sovereigns; capital account pressures; and a broad-based downturn in the global economic activity.	Medium Tighter global financial conditions may lead to large financial outflows and could result in higher borrowing costs for some firms that operate in San Marino. This could also affect public finances, especially if the sovereign seeks external financing.	• Carefully assess alternative options in seeking external financing; • Address financial sector vulnerabilities; and • Apply liquidity safeguard measures on a "as needed" basis.
High **Slow progress in restructuring the banking system,** including addressing recapitalization needs and cleaning up bank balance sheets.	High Insufficient progress in banking sector restructuring will lead to a deterioration of confidence accompanied by significant financial outflows, higher liquidity pressures in the banking system, and retrenchment of credit with adverse growth implications.	• Extend central bank powers and tools for tackling failing banks; • Apply bank resolution tools and liquidity safeguard measures on a "as needed" basis; and • Re-assess and accelerate the implementation targets in a financial sector strategy.
High **Slow fiscal consolidation and delays in implementing fiscal reforms.**	High High level of public debt and a narrow tax base will increase vulnerabilities and limit the government's ability to respond to shocks. A sustained level of high debt service would also crowd out productive spending, thus undermining growth prospects.	• Advance fiscal reforms and develop debt management capacity and establish a Treasury unit; • Diversify financing options; and • Seek technical support as needed.
Medium **Loss of cross-border electronic payment services:** Failure of one or more banks to meet their gross settlements obligations would significantly curtail cross-border payments.	High Disruptions 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.	• Take immediate steps to improve liquidity in the central bank; and • Apply liquidity safeguard measures aimed at restoring the payment system.
Low **Tensions with neighboring Italy resurface.**	High Persistent tensions would dissuade Italian corporates and banks from doing business with San Marino, thus affecting growth.	• Build fiscal buffers and pursue structural reforms; • Enhance international relations; and • Further diversify trade.

[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 is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

Annex III. Reserve Adequacy for San Marino

1. San Marino's system-wide liquidity buffers have declined considerably in recent years. The aggregate liquidity buffers—comprised of international reserves and decentralized liquidity buffer held by commercial banks outside the CBSM[1]—have fallen sharply in 2015–17 on the back of significant deposits outflows by both residents and non-residents, withdrawal of government deposits, and CBSM liquidity support to the banking system and the government. At end-2018, the overall liquidity stood at €758 million, slightly deteriorated from end-2017, and nearly half of the liquidity buffers in 2014.

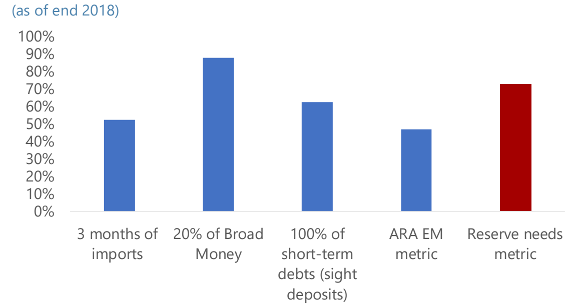
Liquidity buffers
(millions of euros)



Sources: CBSM, MoF and IMF staff.

2. The international reserves appear low by both standard reserve adequacy metrics and the Fund ARA EM metric.[2] Standard metrics such as the imports coverage ratio, the ratio of reserves to short-term external debt, and the ratio of reserves to broad money, indicate that the international reserves in San Marino are below what is considered to be an adequate level, though significant variations exist among these indicators in terms of the size of the reserve shortage. The Fund ARA EM metric—a composite metric designed to better capture a range of capital outflow risks—shows that the international reserves only amount to 47 percent of the metric, significantly below the range which is generally considered to be adequate (100–150 percent). These results suggest the importance for San Marino to build up reserves.

Reserve coverage metrics
(as of end 2018)



Note: ARA EM metric is defined as 10% of exports of goods and services, 30% of non-resident sight deposits, 20% of other liabilities to non-residents, and 10% of broad money. 2018 import/export is an esimate. Broad Money and other liablity data are as of August, 2018.
Sources: CBSM, IMF Monetary and Financial Statistics, and IMF staff.

3. Reserve adequacy assessment in San Marino warrant further analysis taking into account some specificities of the Sammarinese economy. As a fully euroized economy that does not have access to external markets, San Marino largely relies on the international reserves as a buffer against possible liquidity shocks faced by the banking system and the government. The decentralized liquidity buffer could help against liquidity shortages and possible capital outflow risks, yet they cannot fully substitute for the international reserves as they are outside the CBSM's control and, in the absence of a well-functioning interbank market, they can only be used against liquidity pressures of the commercial bank holding the assets.

[1] This includes cash, deposits and loans available within 7 days, and securities that can be readily converted to cash but does not include deposits at CBSM and Sammarinese banks.

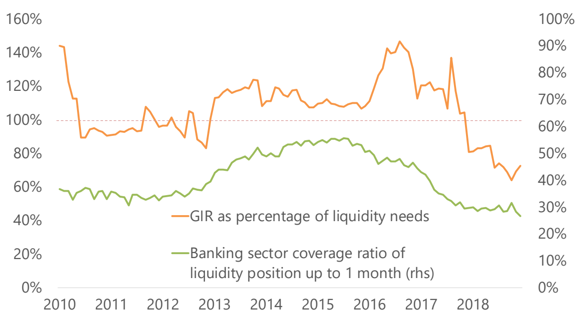
[2] See Guidance note on the assessment of reserve adequacy and related considerations (IMF, 2016).

4. In light of above, staff developed an alternative metric to measure reserve adequacy against liquidity risks in the banking sector and the public sector. Specifically, the metric is composed of the following two elements:

- ***Liquidity needs in the banking sector:*** Demand deposits placed by commercial banks at the CBSM should be readily available for redistribution to commercial banks in need, as they are a part of banks' liquidity buffers. In episodes of acute liquidity pressure, the CBSM should stand ready to provide liquidity to solvent banks, which run out of their own liquidity buffer by easing reserve requirements and provision of loans through a formalized Emergency Liquidity Assistance (ELA) framework. Thus, the metric should cover 100 percent of demand deposits of banks, reserve requirements at the CBSM, and contingent liabilities to banks.

- ***Liquidity needs in the public sector:*** With currently no access to external market, the level of CBSM reserves should also be sufficiently high to provide short-term liquidity support to the government to mitigate fiscal shocks or seasonal financing needs. Additionally, the CBSM accepts demand deposits from other public institutions such as SOEs and pension funds, which should be readily available to the institutions as part of their liquidity management. Thus, the metric covers (i) two standard deviations of the historical series of CBSM financing provided to the government, which are roughly equal to two months of government spending, as fiscal buffer that the CBSM needs to set aside for the government, (ii) any committed credit line the CBSM has given to the government, and (iii) 100 percent of demand deposits from other public institutions.

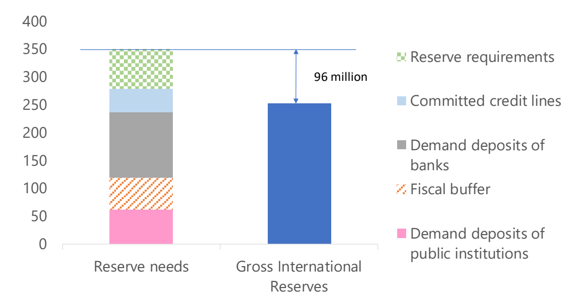
GIR coverage and banking sector liquidity



Note: Reserve coverage is defined as gorss international reserves as a share of the reserve needs. The latter is the sum of (1) reserve requirements, (2) sight deposits (excl. the government deposits), (3) fiscal buffer, and (4) credit lines (expected loans) to banks and the government.
Sources: CBSM and IMF staff calculations.

Reserve Needs

(millions of euros, as of end 2018)



Note: Demand deposits of public institutions exclude the government deposits at the CBSM for liquidity buffer purpose.
Sources: CBSM, IMF Monetary and Financial Statistics, and IMF staff.

5. The proposed metric suggests that the international reserves are well below levels adequate for prudential purposes. The international reserves have fallen to 72 percent of their adequate level at end-2018 from around 120 percent in early-2017 owing to the increased CBSM loans and credit lines to the government and banking sector and investment in illiquid securities. Based on this metric, the gross international reserves at end-2018 are estimated to be €96 million below the minimum reserve level. CBSM may need to hold a higher buffer if further liquidity support to banks and volatility of government cashflows becomes likely.

Annex IV. Implementation of IMF Recommendations

2018 Article IV advice		Action since 2018 Article IV
Financial sector issues	Develop a comprehensive financial sector strategy, complete AQR update, reduce the high level of non-performing loans, and initiate bank balance sheet repair.	The authorities completed the AQR update and started communicating the findings to banks. The CBSM is developing a financial sector strategy, and discussions are being held with banks on their business and NPL reduction plans. A draft legislation to facilitate out-of-court debt restructuring is under preparation.
	Restructure CRSM, and promptly raise capital following upfront loss recognition.	A business restructuring plan for CRSM is still under discussion as well as recapitalization strategy and potential sources for financing.
	Mitigate financial sector risks through development of crisis response capability, strengthening central bank functions and bank oversight. Adopt high standards of governance, accountability, and transparency.	The financial stability committee was established. The authorities have enhanced liquidity monitoring and integrated liquidity projections of banks, the government, and the CBSM. The CBSM is preparing a "Fit and Proper" regulation to improve banking system governance, but no measures were taken to strengthen the CBSM's independence and powers.
Fiscal policy	Develop a fiscal consolidation strategy to ensure debt sustainability. Reform indirect taxes by introducing a Value Added Tax (VAT), and improving the quality and efficiency of spending, and prioritize the pension reform proposal.	The 2019 budget envisages a modest fiscal adjustment, which partly relies on one-off measures. VAT legislation is being prepared with the aim of approving it by mid-2019 and implementing it in early 2020. Pension reform proposals are still under discussion with social partners.
	Develop debt management capacity and diversify financing options.	The government is looking to diversify financing options, but no measures were taken to enhance debt management capacity.
Structural reforms	Continue to engage in international cooperation and improve transparency.	Discussions on the association agreement with the EU are ongoing with the aim of concluding by end-2019/ early 2020. A new Economic Development Agency was established to support greater economic integration and discussions were re-started to sign a Memorandum of Understanding with the Bank of Italy.
	Reduce the cost of doing business and increase labor market flexibility and introduce well-targeted social benefits.	A one-stop-shop was set up to facilitate a more efficient process for establishing a business while other measures to reduce red tape are being evaluated. The authorities are developing a household wealth indicator that will help better target social benefits.
	Continue improving the effectiveness of measures to safeguard financial integrity and further strengthen data provision.	The authorities have developed and started implementing the AML/CFT action plan and are working on a second National Risk Assessment. A working group on BOP statistics has been established and, with support of the Fund technical assistance, the authorities published balance of payments statistics for 2017 and international investment position statistics for 2016–17. Regular publication of BOP data is expected to start in 2019.

Annex V. Debt Sustainability Analysis

Banking system recapitalization needs jeopardize public debt sustainability. Staff's baseline scenario, which includes the states' excessive commitments to the banking system (CRSM's legacy losses and tax credits given to banks) suggests that the implicit public debt stood at about 77 percent of GDP in 2018. This level, which is unsustainable for San Marino given its limited domestic financing options, lack of market access, and weak debt management capacity, highlights the need for an ambitious and durable fiscal adjustment, stronger public debt management, and carefully controlled public sector contributions in the banking system recapitalization strategy to limit public debt increases. While data weaknesses limit the analysis on external indebtedness, gross external debt is projected to decline over the medium term due to continued capital outflows, including from the domestic banking system.

1. **The official public debt figure has yet to fully recognize significant fiscal commitments to the banking system.** The government committed to amortize the CRSM legacy losses, which currently stand at €465 million, over a period of 25 years, but has yet to fully recognize their fiscal cost as part of public debt. Banking system tax credits, which were given to banks to cover the asset-liability gap when they absorbed failed banks, are also not fully recognized as fiscal liabilities. This suggests that the implicit public debt, which staff estimate at about 77 percent of GDP in 2018, is well above the official public debt of 27.5 percent of GDP.[1]

2. **The implicit public debt is projected to remain broadly flat over the medium term**. Staff baseline scenario indicates that the implicit public debt is projected to increase only slightly to 78.3 percent of GDP by 2024 as sustained primary deficits are projected to be offset by growth-interest rate differentials (Figure A5.1). As large part of the estimated implicit public debt has not been incurred by the government yet, gross financing needs are projected to remain at around 5 percent of GDP, increasing over time (Figure A5.2).

3. **A full and upfront recognition of the state's financial commitments to the banking system would bring public debt to an unsustainable level.** The baseline scenario does not consider interest payments on the unrecognized fiscal costs since no debt has been formally issued by the authorities. However, incorporation of estimated interest payments of the implicit public debt would result in an increase of gross financing needs to about 8 percent of GDP (around 30 percent of revenue), posing significant rollover risks, especially given the limited domestic financing options, no market access, and weak debt management capacity.[2] Adverse economic conditions will further amplify these risks (see adverse scenarios below and Figure A5.3). This also implies that the largely green heat map (Figure A5.4) is not indicative for San Marino, as the debt thresholds are calculated for countries with established market access. Staff analysis highlights the need for an ambitious and durable fiscal adjustment, stronger public debt management, and careful design of banking system recapitalization modalities to limit public debt increases.

[1] The sharp increase in the implicit public debt in 2017 follows the 2016 AQR, which identified a significant capital shortfall in state-owned bank, CRSM, mainly due to additional provisions related to Delta portfolio.

[2] The issuance of government debt would result, depending on the structure of debt, in additional 1–1.5 percent of GDP interest payments between 2019–24.

4. **Several adverse scenarios were considered to further assess the sustainability of government debt**. These standardized scenarios, which are applied to the baseline, include low growth, a deterioration in the primary balance, realization of contingent liabilities, and high borrowing costs. The results indicate that public debt is highly vulnerable to adverse macroeconomic conditions:

- *Real growth shock*. Real GDP growth rate is assumed to decline by one-standard deviation below the baseline during 2019–20 and the interest rate increase by 25 basis points for one percent of GDP deterioration of the primary balance compared to the baseline. Under this scenario, the public debt ratio would increase to 82 percent of GDP by 2020, and to 90 percent of GDP by 2024.

- *Primary balance shock*. A deterioration of 1.5 percentage points of GDP in the primary balance in both 2019–20 is expected to increase the public debt by 3 percentage points relative to the baseline, reaching 81 percent of GDP by 2024.

- *Contingent liability shock*. Additional costs related to banking system repair (10 percent of GDP) accompanied by lower growth in 2019–20 and higher borrowing cost (by additional 300 basis points) will increase public debt rapidly in an unsustainable manner to about 100 percent of GDP by 2024. Gross financing needs increase to about 9 percent of GDP.

- *Real interest rate shock*. Under this scenario, which envisages an interest rate increase of 300 basis points, public debt is projected to increase to 80 percent of GDP by 2024.

- *Combined macro-fiscal shock*. Under this scenario, which is a combination of the above shocks (excluding the contingent liability shock), the public debt would reach 84 percent of GDP by 2020, and then gradually increase to 93 percent of GDP by 2024.

5. **San Marino's gross external debt is set to decline on the back of continued, albeit more moderate, capital outflows.** San Marino's gross external debt stood at 89 percent of GDP in 2017, where deposit liabilities of deposit-taking corporations accounted for the largest component. With continued capital outflows, including from the banking system, gross external debt is projected to have declined to 78 percent of GDP in 2018 and remain on a downward trajectory over the medium term, reaching a level of 53 percent of GDP by 2024. All else equal, lower growth, a deterioration in the current account, and a slower price growth relative to that in key trading partners (real exchange rate depreciation) would result in a higher trajectory of external debt relative to the baseline.

6. **The analysis is subject to a number of caveats reflecting limited data availability**. First, due to lack of data, gross external debt does not include FDI debt instrument liabilities, and as a result, gross financing needs may be underestimated. In addition, limited availability of external sector historical data required making assumptions about averages and standard deviations of key variables, such as non-interest current account balance, export and import growth, and non-debt creating capital flows, that are used for the stress tests.

Figure A5.1. San Marino: Public Sector Debt Sustainability Analysis (DSA)—Baseline Scenario

(In percent of GDP unless otherwise indicated)

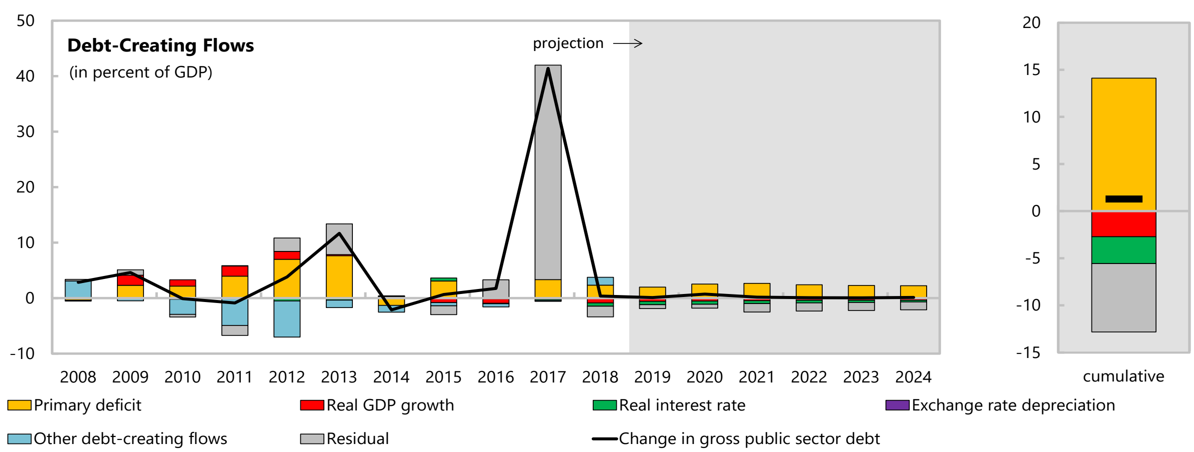
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2011-2016 [2/]	2017	2018	2019	2020	2021	2022	2023	2024
Nominal gross public debt	29.9	76.6	77.0	77.1	77.9	78.0	78.1	78.2	78.3
Public gross financing needs	4.2	4.5	3.9	3.9	4.9	5.6	5.8	6.1	6.5
Real GDP growth (in percent)	-2.0	0.6	1.1	0.8	0.7	0.6	0.5	0.5	0.5
Inflation (GDP deflator, in percent)	1.0	1.4	1.3	1.3	1.4	1.5	1.5	1.5	1.5
Nominal GDP growth (in percent)	-1.0	2.0	2.5	2.1	2.1	2.1	2.0	2.1	2.1
Effective interest rate (in percent) [4/]	0.6	0.8	0.5	0.6	0.7	0.8	0.9	1.0	1.2

As of December 03, 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							
	2008-2016	2017	2018	2019	2020	2021	2022	2023	2024	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	2.5	41.4	0.4	0.1	0.7	0.2	0.1	0.1	0.1	1.3	
Identified debt-creating flows	1.2	2.7	2.3	0.8	1.4	1.7	1.6	1.5	1.6	8.5	
Primary deficit	3.4	3.3	2.3	2.0	2.5	2.7	2.4	2.3	2.2	14.1	-0.7
Primary (noninterest) revenue and grants	23.0	22.1	22.9	20.9	20.9	20.6	20.7	20.7	20.6	124.5	
Primary (noninterest) expenditure	26.4	25.4	25.3	22.9	23.5	23.3	23.1	23.0	22.9	138.6	
Automatic debt dynamics [5/]	0.3	-0.4	-1.5	-1.2	-1.1	-1.0	-0.9	-0.8	-0.7	-5.6	
Interest rate/growth differential [6/]	0.3	-0.4	-1.5	-1.2	-1.1	-1.0	-0.9	-0.8	-0.7	-5.6	
Of which: real interest rate	0.0	-0.2	-0.6	-0.6	-0.6	-0.5	-0.5	-0.4	-0.3	-2.8	
Of which: real GDP growth	0.4	-0.2	-0.8	-0.6	-0.5	-0.5	-0.4	-0.4	-0.4	-2.7	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-2.5	-0.2	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Drawdown of deposits and other operat	-2.5	-0.2	1.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	1.3	38.6	-1.9	-0.7	-0.7	-1.5	-1.5	-1.5	-1.4	-7.3	



Source: IMF staff.

1/ Public sector is defined as central government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

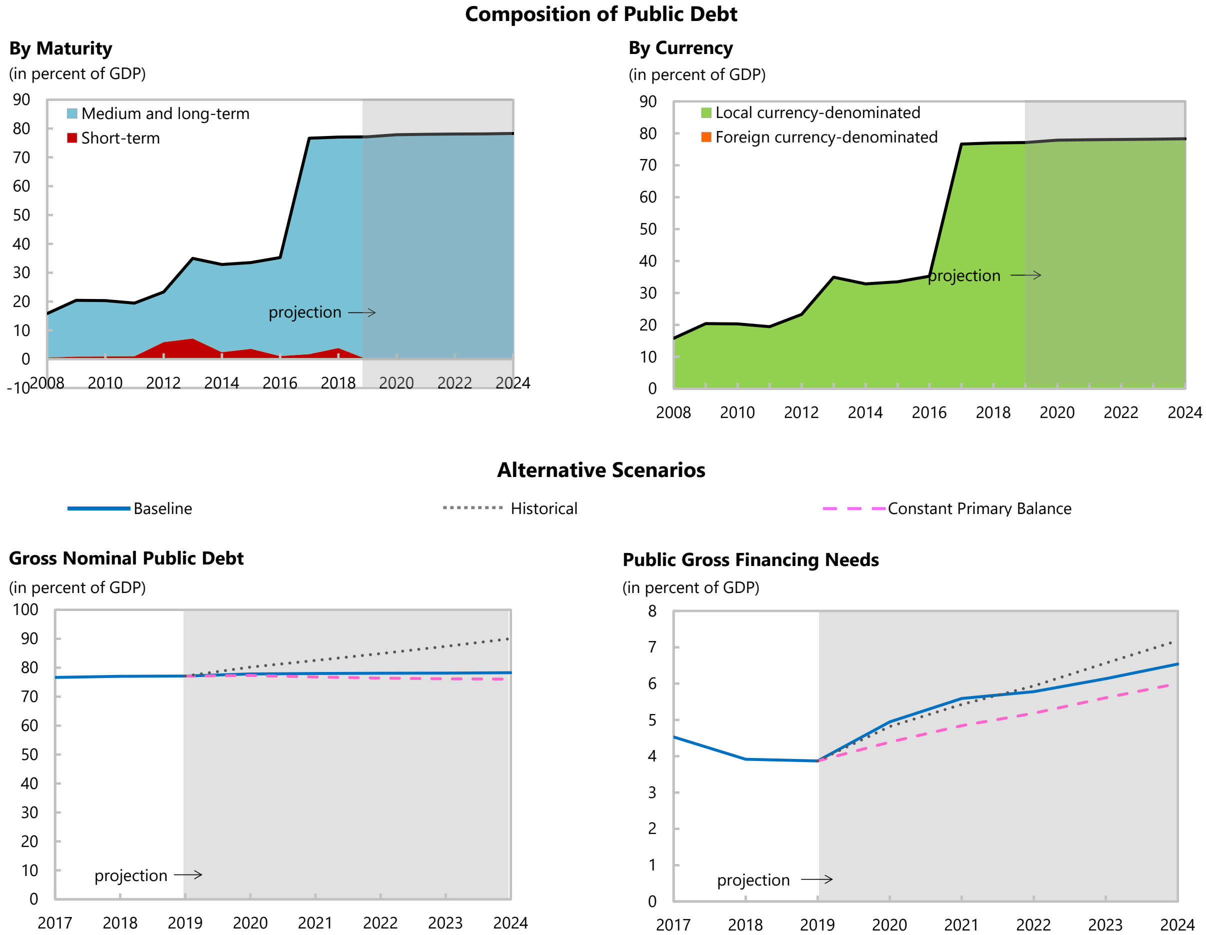
6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

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

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

Figure A5.2. San Marino: Public DSA—Composition of Public Debt and Alternate Scenarios



Underlying Assumptions
(in percent)

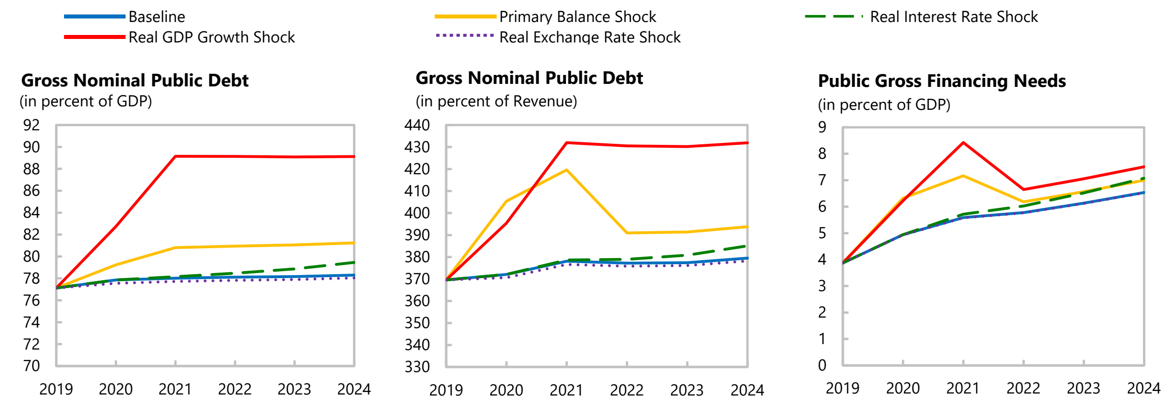
Baseline Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.8	0.7	0.6	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary Balance	-2.0	-2.5	-2.7	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	0.8	0.9	1.0	1.2
Constant Primary Balance Scenario						
Real GDP growth	0.8	0.7	0.6	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary Balance	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0
Effective interest rate	0.6	0.7	0.8	0.9	1.0	1.1

Historical Scenario	2019	2020	2021	2022	2023	2024
Real GDP growth	0.8	-2.6	-2.6	-2.6	-2.6	-2.6
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary Balance	-2.0	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	0.6	0.7	0.8	0.9	1.0	1.2

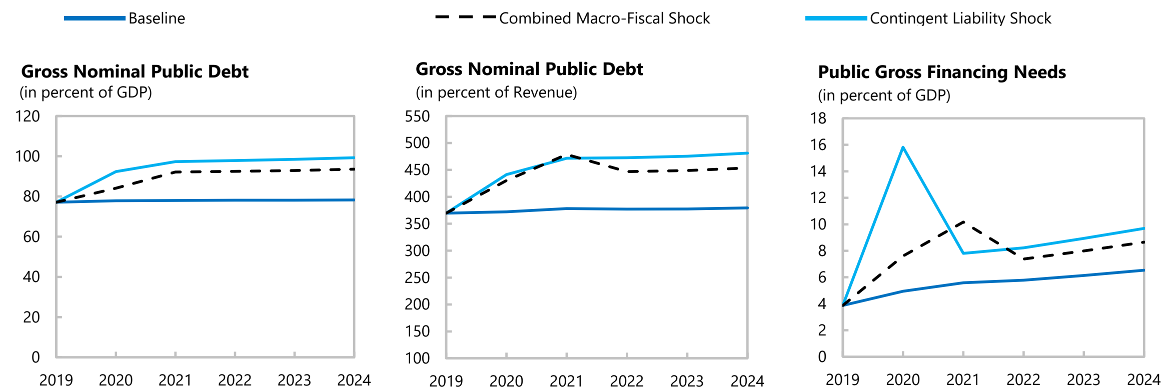
Source: IMF staff.

Figure A5.3. San Marino: Public DSA—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

	2019	2020	2021	2022	2023	2024
Primary Balance Shock						
Real GDP growth	0.8	0.7	0.6	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary balance	-2.0	-3.9	-4.0	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	0.8	1.0	1.1	1.3
Real Interest Rate Shock						
Real GDP growth	0.8	0.7	0.6	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary balance	-2.0	-2.5	-2.7	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	1.0	1.2	1.5	1.8
Combined Shock						
Real GDP growth	0.8	-4.0	-4.1	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary balance	-2.0	-5.1	-6.4	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	1.1	1.5	1.8	2.0

	2019	2020	2021	2022	2023	2024
Real GDP Growth Shock						
Real GDP growth	0.8	-4.0	-4.1	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary balance	-2.0	-3.7	-5.0	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	0.8	1.1	1.2	1.3
Real Exchange Rate Shock						
Real GDP growth	0.8	0.7	0.6	0.5	0.5	0.5
Inflation	1.3	1.8	1.5	1.5	1.5	1.5
Primary balance	-2.0	-2.5	-2.7	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	0.8	0.9	1.0	1.2
Contingent Liability Shock						
Real GDP growth	0.8	-4.0	-4.1	0.5	0.5	0.5
Inflation	1.3	1.4	1.5	1.5	1.5	1.5
Primary balance	-2.0	-13.3	-2.7	-2.4	-2.3	-2.2
Effective interest rate	0.6	0.7	1.5	1.7	2.0	2.2

Source: IMF staff.

Figure A5.4. San Marino: Public DSA—Risk Assessment

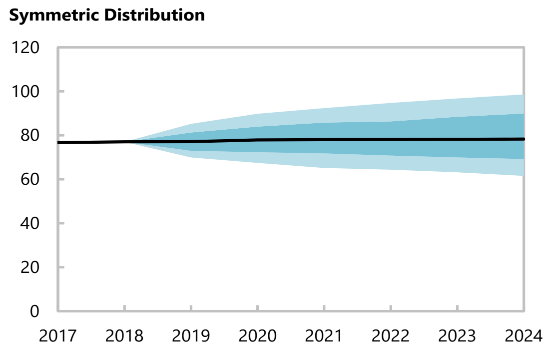
Heat Map

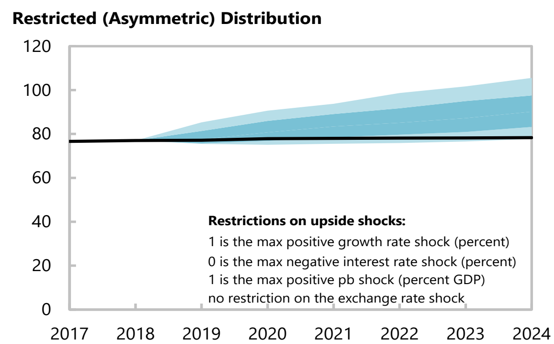
Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)

Baseline   Percentiles: 10th-25th   25th-75th   75th-90th

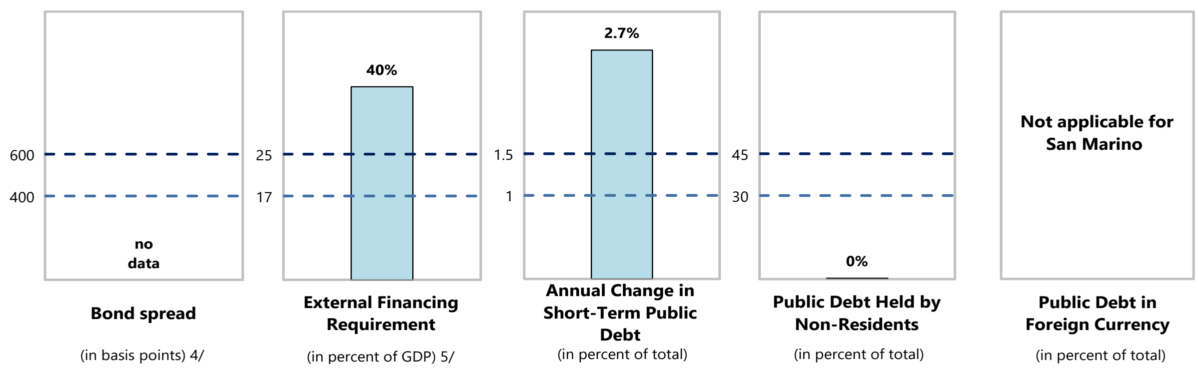




Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2018)

San Marino   Lower early warning   Upper early warning



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

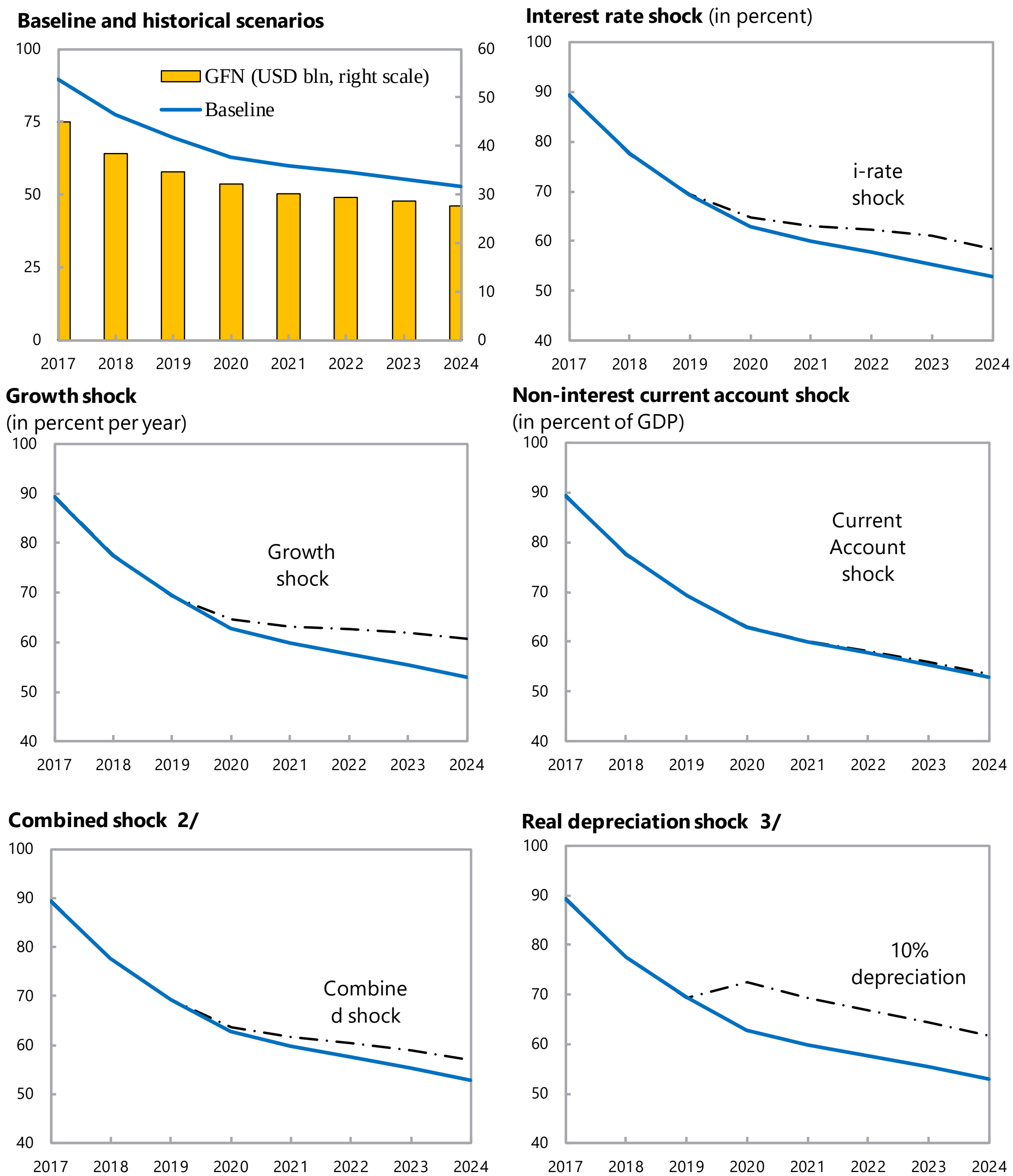
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 04-Sep-18 through 03-Dec-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure A5.5. San Marino: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 10 percent occurs in 2020. Because San Marino is a fully euroized economy, the real depreciation entails a one-time 10 percent decline in the domestic price level.

Table A5.1. San Marino: External Debt Sustainability Framework, 2017–24

(In percent of GDP, unless otherwise indicated)

		Actual			Projections							
		2017			2018	2019	2020	2021	2022	2023	2024	Debt-stabilizing non-interest current account 6/
1	Baseline: External debt	89.4			77.6	69.3	62.8	59.9	57.7	55.4	52.9	1.9
2	Change in external debt	-			-11.9	-8.2	-6.5	-3.0	-2.2	-2.3	-2.5	
3	Identified external debt-creating flows (4+8+9)	-			6.5	2.9	3.2	2.1	1.8	1.7	1.6	
4	Current account deficit, excluding interest payments	0.5			-0.4	-0.3	-0.2	-0.1	-0.1	-0.1	-0.3	
5	Deficit in balance of goods and services	-7.3			-7.6	-7.2	-6.7	-6.5	-6.5	-6.6	-6.7	
6	Exports	159.4			160.0	160.9	161.3	161.7	162.4	163.1	163.8	
7	Imports	152.1			152.4	153.7	154.6	155.2	155.9	156.5	157.1	
8	Net non-debt creating capital inflows (negative)	10.5			7.8	3.8	3.8	2.5	2.2	2.1	2.1	
9	Automatic debt dynamics 1/	-			-0.9	-0.6	-0.4	-0.3	-0.3	-0.2	-0.2	
10	Contribution from nominal interest rate	-			0.0	0.0	0.0	0.0	0.0	0.1	0.1	
11	Contribution from real GDP growth	-			-0.9	-0.6	-0.5	-0.4	-0.3	-0.3	-0.3	
12	Contribution from price and exchange rate changes 2/	-										
13	Residual, incl. change in gross foreign assets (2-3) 3/	-			-18.4	-11.1	-9.7	-5.0	-4.0	-4.0	-4.2	
	External debt-to-exports ratio (in percent)	56.1			48.5	43.1	39.0	37.0	35.5	34.0	32.3	
	Gross external financing need (in billions of euros) 4/	0.6			0.5	0.5	0.5	0.4	0.4	0.4	0.4	
	in percent of GDP	44.9	10-Year	10-Year	36.6	33.5	30.7	28.6	27.5	26.7	25.9	
	Scenario with key variables at their historical averages 5/				77.6	68.3	72.5	80.8	90.5	99.9	108.8	12.5
	Key Macroeconomic Assumptions Underlying Baseline		Historical Average	Standard Deviation								
	Real GDP growth (in percent)	0.6	-3.0	4.8	1.1	0.8	0.7	0.6	0.5	0.5	0.5	
	GDP deflator (change in domestic currency)	1.4	1.1	1.1	1.3	1.3	1.4	1.5	1.5	1.5	1.5	
	Nominal external interest rate (in percent)	-	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	
	Growth of exports (in percent)	-	0.0	0.0	2.9	2.7	2.4	2.4	2.5	2.5	2.5	
	Growth of imports (in percent)	-	0.0	0.0	2.7	3.0	2.7	2.5	2.5	2.4	2.5	
	Current account balance, excluding interest payments	-0.5	-0.5	0.0	0.4	0.3	0.2	0.1	0.1	0.1	0.3	
	Net non-debt creating capital inflows	-10.5	-10.5	0.0	-7.8	-3.8	-3.8	-2.5	-2.2	-2.1	-2.1	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator)

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
Due to lack of data, it has been assumed that short-term external debt is equal to one third of total external debt, while medium- and long-term amortization amounts to 10 percent of nominal GDP.
These assumptions reflect Italian external debt data.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

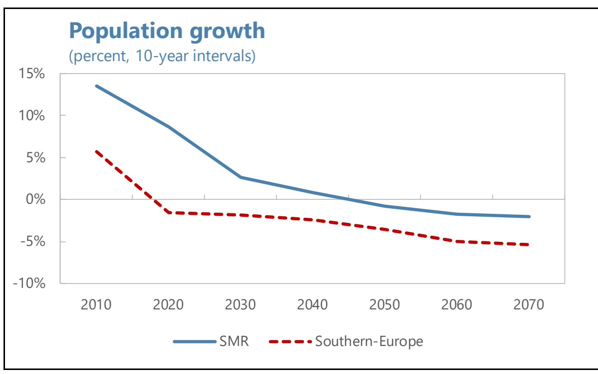
Annex VI. Demographic Pressure and Pension Reform[1]

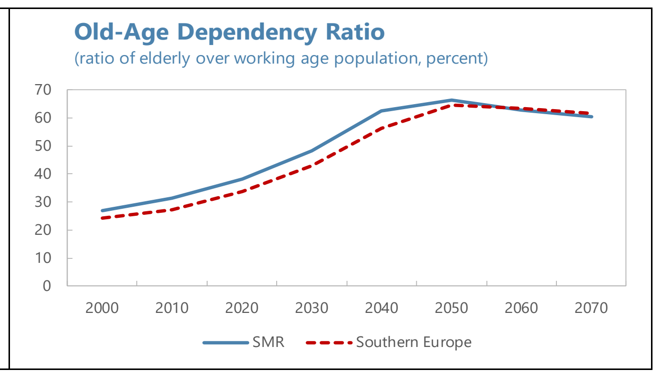
A. Introduction

1. Population ageing will pose significant fiscal challenges in San Marino. With projected fertility rates remaining below replacement levels in the future, a slower population growth and high life expectancy are expected to triple the old-age dependency ratio over the next forty years, posing significant challenges to the sustainability of the welfare system. The authorities' efforts to address the demographic pressures and implement a pension reform as part of their National Stability and Development Plan are timely, particularly given the fiscal risks that are related to banking system recapitalization and the needed fiscal adjustment to ensure public debt sustainability.

B. Demographic Outlook

2. Slow population growth and high longevity will lead to a rapidly ageing society. According to UN projections (*2017 Revision of the UN World Population Prospect*), San Marino's population will continue to grow in the coming decades, but at a gradually slower pace. The population will start declining by 2050, in line with trend observed in other EU countries, as the fertility rate, which is already below replacement levels (1.33 births per woman), is expected to remain low over the coming decades.[2] In addition, the average life expectancy in San Marino is 84.6 years and among the highest in the world, reflecting in part the universal coverage and quality of the health care system.[3] With a ratio of people aged 65 and older to those aged 15 to 64 years already reaching 30 percent in 2017, a level close to the EU average, the old-age dependency ratio is expected to significantly increase in the coming decades. According to staff projections, this ratio is





[1] Prepared by Salvatore Dell'Erba (EUR), with helpful comments and suggestions from Mauricio Soto and Csaba Feher (FAD).

[2] Due to the considerable uncertainty surrounding long-term demographic projections, the UN produces three different scenarios, a "low", "medium" and "high" scenario characterized by different assumptions on the assumed fertility rates. The results presented here are based on the medium-variant projection, which assumes that the global fertility level will decline from 2.5 births per woman in 2010–15 to 2.2 in 2045–50, and then fall to 2.0 by 2095–2100.

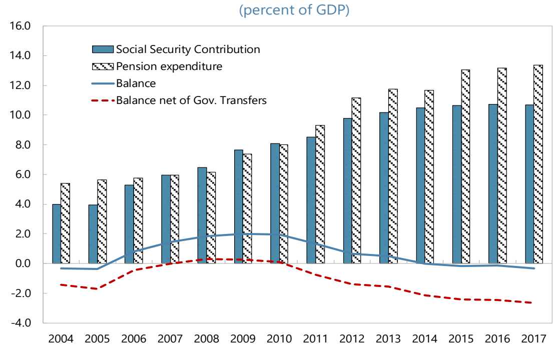
[3] Evans, D, A. Tandon, C. Murray, and J. Lauer, 2000, "The Comparative Efficiency of National Health Systems in Producing Health: An Analysis of 191 Countries," GPE Discussion Paper No. 29, EIP/GPE/EQC, World Health Organization, Geneva.

expected to reach 60 percent by 2050 and stabilize thereafter, thus impacting the already generous social security system, whose biggest outlays are concentrated on pensions and healthcare (see Box A6.1).[4]

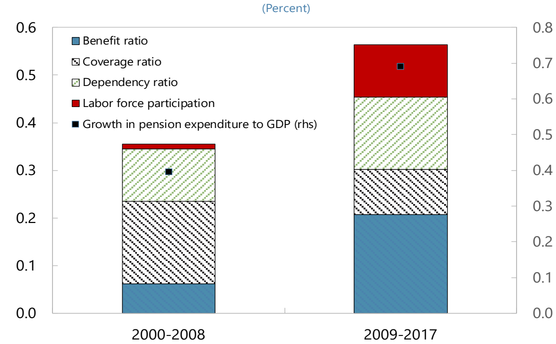
C. Challenges from Population Ageing

3. Spending on pensions has increased rapidly. As a share of GDP, spending on pensions has more than doubled since 2004, rising from 5 percent to about 13 percent in 2017. This rapid increase has occurred despite the two pension reforms approved in 2005 and 2011, which were implemented to address the negative impact of demographic pressures. Several factors contributed to this development.[5] First, thanks to increased longevity, the increase in the old-age dependency ratio has steadily contributed to more spending on pensions for the same level of GDP. Second, spending per pensioner has grown faster than GDP per worker due to the economic crisis and the contraction in GDP that followed. While an increase in contribution rates and an extension of the contributory periods approved during the past reforms have positively affected overall contributions as a share of GDP, their growth has stalled in the aftermath of the crisis due to lower labor force participation. Moreover, the ratio of pensioners to population aged 65 and older has increased from 107 in 2000 to 138 percent in 2017, contributing to a deterioration in the pension fund's deficit.

Pension Fund Contributions, Spending and Balance
(percent of GDP)



Change in ordinary pension expenditures
(Percent)



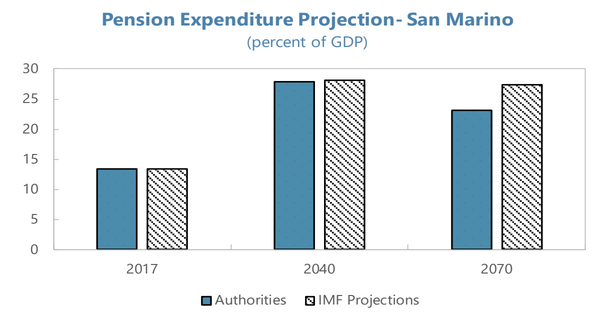
Source: Sammarinese authorities and IMF staff.

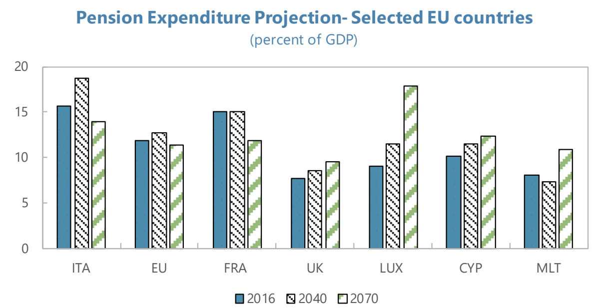
4. Pension spending is projected to increase further owing to continued demographic pressure. In a baseline scenario, spending on pensions is projected to reach around 26 percent of GDP by 2040 and slowly decline to 25 percent by 2070. This projection, which is broadly consistent with the authorities' official estimates, assumes that growth of pensions in San Marino is only determined by the growth of old-age dependency ratio (IMF projections).

[4] The UN does not provide projections for the old-age dependency ratio for San Marino. San Marino's old-age dependency ratio is projected using the Economic Policy Committee's Working Group on Ageing Populations and Sustainability projections for Italy.

[5] Pension expenditure to GDP is the product of four main factors: the benefit ratio (average pension divided by GDP per worker); the coverage ratio (pensioners per population aged 65 and older); the inverse of the labor force participation and the old-age dependency ratio (population of 65 and older to population 15–64). See IMF (2015). The chart focuses on the growth of ordinary pensions, excluding privileged pensions.

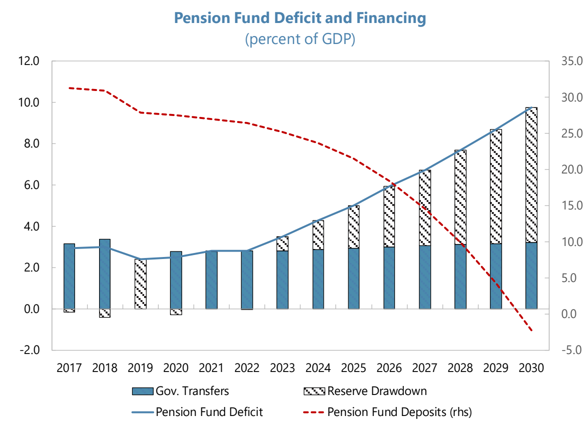
5. The trajectory of pensions spending in San Marino exceeds that in many EU countries. On average, spending on pension is expected to remain broadly constant in percent of GDP at the EU level: it will slightly increase in 2040 and then decline by 2070. This bell curve trajectory is also observed in Italy, with pensions spending trending upward until 2040, and then slow down by 2070 as the impact of the pension system stabilizers and past reforms start to produce their effects (European Commission, 2018). For other EU countries for which pension spending is expected to follow an upward trend, the increase is more modest compared to what is expected in San Marino.





Source: Sammarinese authorities, Commission services, Economic Policy Committee.

6. The current pension system is unsustainable. Notwithstanding the impact of previous pension reforms, the deficit of the pension fund is projected to reach 10 percent of GDP by 2030. Assuming that the central government transfers to ISS are kept at a maximum of 25 percent of total contributions, these will likely be insufficient to finance the deficit, requiring a drawdown of reserves. While the reserves accumulated in the pension fund are currently high (about 27 percent of GDP), they are projected to contribute to the financing of the deficit only up to 2030, before depleting and exercising unsustainable pressures on the budget. This rapid depletion of pension fund reserves may also have systemic implications for the banking system given the already low level of liquidity. This highlights the need for further pension reforms to safeguard financial and fiscal sustainability.



Source: Sammarinese Authorities and staff estimates.

D. Reform Options

7. Past reforms have increased retirement age and contribution rates while introducing a second, fully-funded pillar. Statutory retirement ages for both females and males have been brought in line with those observed in other EU countries (Table A6.1) and are set to increase to 66 years by 2021. The minimum years of contributions for old-age retirement has been increased to 20 years, though early retirement is now possible at age 60 with at least 40 years of contributions. The reforms have progressively increased and equalized the mandatory contribution rates across various categories of workers. The 2011 reform introduced a second pillar, a capitalization system, mandatory for both dependent and self-employed, administered by the Fondo di Previdenza Complementare della Repubblica di San Marino (FONDISS).[6] The 2019 Budget has reduced the favorable fiscal treatment of pension income compared to general income, by reducing the income tax deduction on pensions.

8. Despite these reforms, pension benefits in San Marino remain among the highest in Europe. The benefit ratio (average pensions divided by average wages) is 71 percent and is high compared to an EU average of 50 percent (Table A6.1). While past reforms have reduced the replacement rate, pensions remain generous compared to other systems.[7] Pensionable earnings included in the calculation of the benefits are based on the previous 20 years before retirement, which leads to higher pension spending. Many countries have instead adopted pension benefits formulas which use the full career earnings as the reference to calculate pension entitlements, thereby linking benefits and contributions, while retirement ages increase automatically with life expectancy. Also, on average, accrual rates in Europe are between 1.5 and 1.7 percent, which on average guarantees replacement rates around 50 percent.

9. Early retirement options are generous. The system has two types of early retirement: the early retirement without penalties ("quota 100") and early retirement with penalties. Both types affect heavily the sustainability of pension spending considering the demographic changes and steady reduction in the number of employee per pensioner. Furthermore, the penalties for early retirement before age 60 are exceptionally low: retiring at 57 (i.e. eight years before the normal retirement age) incurs a total penalty of 20 percent while, in comparator countries, the total reduction ranges between 38.4 and 57.6 percent. Retiring six years early incurs a penalty of 10 percent—only one-third to one-fourth of what other countries apply in order to discourage early retirement.

10. Further changes will be needed to stabilize the pension deficit. As the system is already registering a structural deficit, the proposed reforms should focus on reducing the pension system funding gap, limiting the amount of resources transferred from the public budget and sustaining future fiscal sustainability (see DSA, Annex V). The policies needed to address imbalances in pension systems will require changes to the parameters of the system, like statutory retirement age, contribution rates and the way benefits are calculated. The combination of these policy changes should be designed to guarantee that public pensions provide for adequate living standards.

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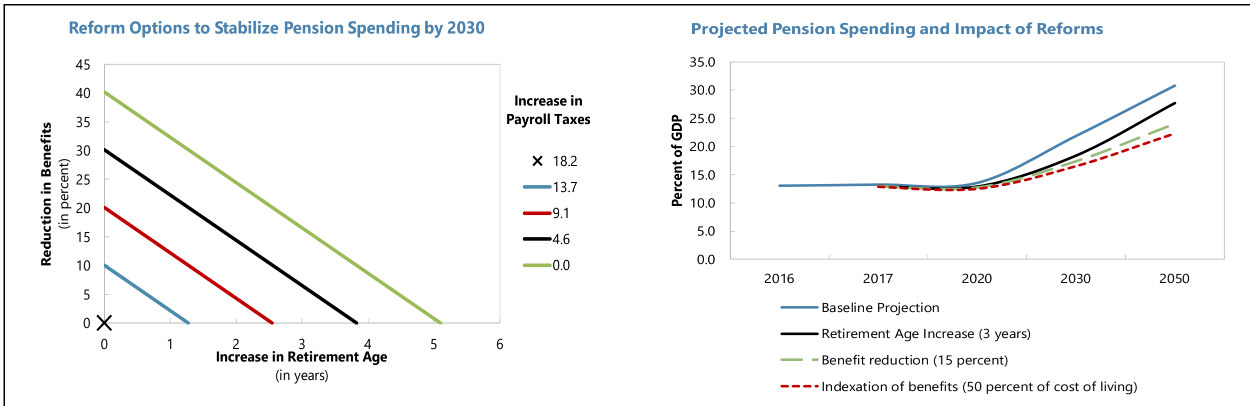
[6] The contribution rates for the mandatory individual accounts are 2 percent of gross earnings (payroll) for employees (employers) and 3 percent of income for self-employed.

[7] The benefit is calculated as follows. An accrual rate 2 percent is multiplied by the numbers of year of contributions until half of the legally established average annual income (€45,501 for 2018), a 0.75 percent rate (1.5 percent for coverage before 2012) is used for the excess amount, leading to an average replacement rate of 55 percent. The reference earnings used to calculate the benefit are the average daily earnings of the last 20 years (10 year before 2012) before retirement, adjusted for the cost of living index, divided by the number of contributing days and multiplied by 16.615.

11. The scope for further parametric reforms could be conducted through a careful actuarial review in the context of the ongoing policy discussions. Reform proposals currently discussed include an increase in retirement age, the passage to a defined contribution system and incentives for complementary pensions (see Box A6.2). Further changes might be necessary to stabilize pension spending. As a way of illustrating the trade-offs involved when it comes to parametric reforms,[8] if San Marino were to stabilize pension spending at 13.3 percent of GDP by 2030, it would be necessary to reduce pension benefits across the board by 40 percent without increasing payroll taxes or retirement age. On the other hand, stabilization of pension spending could be obtained by increasing retirement age by 5.1 years, without cutting benefits or increasing payroll taxes, or increasing payroll taxes by 18.2 percentage points without raising retirement age of cutting benefits. Any combination of the above policies could still stabilize the pension spending (see chart below),[9] with a modest increase in social contributions rates.[10] These policies will not fully eliminate the funding gap and may require further state support. However, capping state support at 2 percent of GDP could lead to saving of about 1 percent of GDP per year while allowing to stabilize pension reserves by 2030. Other reforms currently under discussion could be introduced to permanently stabilize pension deficit after 2030 and ensure that the fiscal transfers and liquidity levels remain adequate and do not jeopardize fiscal sustainability and financial stability. To ensure these policy objectives are achieved, more detailed pension fund projections will be needed.



Source: IMF staff

[8] The following calculations are based on a simplified pension expenditure projection model developed by the Fiscal Affairs Department, with the aim to illustrate policy options and identify tradeoffs. They are not based on an actuarial analysis and therefore the results are subject to caveats.

[9] Allowing an increase in retirement age by 3 years by 2030 (a policy in line with what is projected in Italy, for instance) would yield a further reduction in pension expenditure by 3.5 percentage points of GDP. A benefit reduction (15 percent) targeted to higher pensions (above the minimum established legal income) could yield another 1.2 percent of GDP in savings. Providing full indexation only to lower pensions and partial indexation to pensions above the minimum, bringing the average indexation to 50 percent could yield another 0.8 percent of GDP in savings. These set of reforms could thus reduce the pension spending by 5.5 percentage points of GDP by 2030 compared to the no reform baseline scenario.

[10] An increase in social contributions by 3 percentage points would yield about 1.3 percentage points of GDP in savings. This increase would maintain the total contribution rates still below the levels observed in Italy, allowing San Marino to maintain a competitive edge in attracting cross-border businesses and workers, but it could be an upper bound estimate. This reform, coupled with the reforms presented above, would reduce the pension deficit by 6.8 percent overall.

Table A6.1. Public Pension Systems and Demographic Indicators in Selected European Countries

	Benefit Ratio 1/	Statutory Retirement Age (Early Retirement) Male 2/	Statutory Retirement Age (Early Retirement) Female 2/	Dependency ratio 3/	Coverage ratio 4/
San Marino	70.9	65.6 (60)	65.6 (60)	29.7	136.9
Austria	50.5	65 (60)	60 (55)	27.6	146.8
Belgium	41.8	65 (62)	65 (62)	28.4	134.2
Cyprus	62.9	65 (65)	65 (65)	22.2	117.2
Denmark	41.7	65 (61.5)	65 (61.5)	29.5	123.5
Finland	53.5	66 (63)	66 (63)	32.8	127.4
France	50.5	66.3 (61.3)	66.3 (61.3)	30.4	152.9
Germany	42	65.5 (63)	65.5 (63)	32.2	129.6
Greece	77	67 (62)	67 (62)	33.4	113.7
Luxembourg	51.8	65 (57)	65 (57)	20.6	229.3
Ireland	26.8	65.4 (65.4)	65.4 (65.4)	20.9	145.2
Italy	58.9	66.6 (63.6)	66.6 (63.6)	34.5	112.1
Malta	49.2	62 (61)	62 (61)	29.1	101.5
Netherlands	35.7	65.5 (65.5)	65.5 (65.5)	28.1	129.3
Portugal	57.5	66.2 (60)	66.2 (60)	32.1	126.0
Spain	57.7	65.3 (63)	65.3 (63)	28.6	108.1
Sweden	38.6	67 (61)	67 (61)	31.6	127.3
United Kingdom	27.8	65.4 (65.4)	63.1 (63.1)	27.9	111.6

Sources: EU Commission, Sammarinese authorities, and IMF staff calculations.

1/ The benefit ratio is the average pension divided by the average wage.

2/ As of 2016. As of 2019 for San Marino

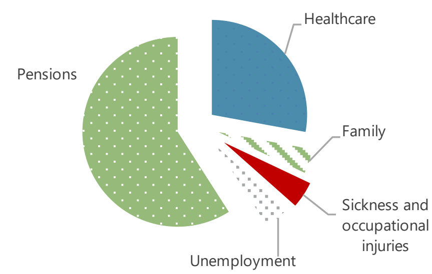
3/ The dependency ratio is the ratio between persons aged 65 and over and persons aged 15-64.

4/ The coverage ratio is the total number of pensioners as a share of the population aged 65 and over.

Box A6.1. San Marino's Social Security System

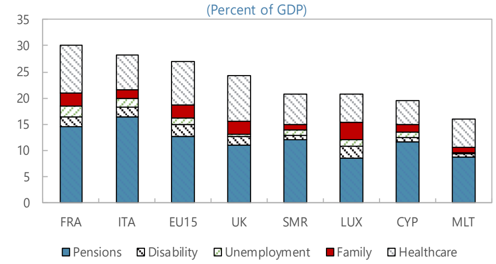
San Marino provides a wide range of social security benefits. The system of social security is managed by the Institute for Social Security (ISS), a public entity partly financed by the central government. Spending on social security benefits by ISS can be classified into three main groups: healthcare, temporary benefits, pensions. Spending on healthcare and pensions account for more than 85 percent of total spending. The remaining share, which is spending on temporary benefits, is represented by family allowances, unemployment-related benefits and compensations for occupational sickness and injuries. As of end-2017, spending on social security totaled €295 mill. (21 percent of GDP).

Social Protection Benefits
(Share of Total Value)



Spending on pension is aligned with EU average. When compared to national income, the level of spending on social security is below the level observed in bigger countries like France, UK and Italy, but somewhat above the level observed in countries with smaller population size, like Malta and Cyprus. San Marino spends relatively less than the EU average on healthcare and other benefits, while spending on pension is close to the EU average. Also, in relative terms, San Marino spends a higher amount on pensions compared to the rest of the EU by almost ten percentage points, a level which is similar to Italy and Cyprus.

Social Protection Spending by Function
(Percent of GDP)



Box A6.2. Pension Reform Proposals

The government has been discussing with social parties a set of reforms to address the sustainability of the pension system. While the discussions are ongoing and a draft reform is not available, these are some of the proposals that the government has advanced:

- **Increase in retirement age.** A minimum retirement age of 63 years with 40 years of contributions ("Quota 103") for early retirement and an increase in statutory retirement age to 67 years for old-age pensions.
- **Defined contribution.** The introduction of a defined contribution mechanism based on actuarially fair rules.
- **Automatic adjustment.** The retirement age would be automatically linked to life-expectancy.
- **Part-time retirement**. The mechanism would enable workers approaching retirement age to reduce their working hours and to be granted an early partial seniority pension.
- **Working in retirement.** Retirees benefitting from old-age pension would be allowed to continue to work and pay into the pension funds.
- **Means-testing.** The minimum pensions would satisfy a means-test.
- **Expanding complementary pensions.** The proposals intend to incentivize the use of complementary pension systems. These include increasing the deductibility of contributions paid by employers and workers and governance reforms to improve investment rules which provide inadequate returns.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

March 5, 2019

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of January 31, 2019)

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	8.83	56.84

Outstanding Purchases and Loans

None

Latest Financial Arrangements

None

Projected Obligations to Fund 1/
(SDR Million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2019	**2020**	**2021**	**2022**	**2023**
Principal					
Charges/Interest	0.07	0.07	0.07	0.07	0.07
Total	0.07	0.07	0.07	0.07	0.07

1/ When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

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 due to 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 8–17, 2018, and the consultation was concluded on March 22, 2018 (IMF Country Report No. 18/101).

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
2018	FAD Foundations for a Value Added Tax
2018	FAD VAT Administrative Readiness Assessment
2018	STA Balance of Payments statistics

Resident Representative: None

STATISTICAL ISSUES

(As of January 31, 2019)

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. National 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. Following technical assistance provided by the IMF Statistics Department, San Marino started compiling balance of payments and international investment position (IIP) in 2018.
National Accounts: National accounts data for 2007 onward have been calculated in accordance with ESA95, and data are compiled annually based on production, and expenditure approach, 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 but has been discontinued. A purchasing managers' index has been compiled starting in 2010.
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 2004–17, and preliminary data 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: In 2018, the Central Bank of San Marino began using the standardized Report Forms to submit Monetary and Financial Statistics to the Fund for use in surveillance and for dissemination in *International Financial Statistics*. Data for Other Financial Corporations are not available. There is a need for improving the classification of commercial bank assets/liabilities.
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. The authorities should shift to a timelier provision of quarterly FSI data to the Fund with a time lag of no more than four months.
External Sector Statistics: In 2018, San Marino started compiling balance of payments and IIP. Frequency, coverage and reporting should be improved. Data are reported once a year and with a long lag. In addition, there are several data gaps in the balance of payments, IIP, and external debt components. Going forward, the authorities should sustain efforts to improve the frequency, coverage, and reporting of relevant statistics.

San Marino: Table of Common Indicators Required for Surveillance
(As of January 31, 2019)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]
Exchange Rates	Jan 2019	Jan 2019	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug 2018	Nov 2018	M	M	M
Reserve/Base Money	Aug 2018	Nov 2018	M	M	M
Broad Money	Aug 2018	Nov 2018	M	M	M
Central Bank Balance Sheet	Aug 2018	Nov 2018	M	M	M
Consolidated Balance Sheet of the Banking System	Aug 2018	Nov 2018	M	M	M
Interest Rates[2]	June 2018	Aug 2018	M	M	M
Consumer Price Index	Dec 2018	Jan 2019	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	2017	Jun 2018	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	2017	Jun 2018	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt[5]	2018	Dec 2018	A	A	A
External Current Account Balance	2017	Sep 2018			
Exports and Imports of Goods and Services	Oct 2018	Dec 2018	M	M	M
GDP/GNP	2017	Dec 2018	A	A	A
Gross External Debt	2017	Sep 2018	A	A	A
International Investment Position[6]	2017	Sep 2018	A	A	A

[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] Deposit and lending rates.
[3] Foreign, domestic banks, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] 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).

Statement by Domenico Fanizza, Executive Director for the Republic of San Marino, and Francesco Spadafora, Senior Advisor to the Executive Director
March 22, 2019

The authorities of the Republic of San Marino reiterate their appreciation for the candid and cooperative discussions held with Fund staff during the Article IV consultation and very much value their recommendations, tailored advice and technical assistance. The authorities broadly concur with the staff's analysis and will continue to rely on the Fund's recommendations to safeguard financial stability and strengthen growth.

Economic growth slowed down in 2017 but is expected to recover in 2018, albeit at a moderate pace of around 1.1 percent, held back by subdued domestic and external demand. After peaking at 10 percent in early 2016, the unemployment rate has declined to around 8 percent, with important recent employment gains—4 percent in the private sector with respect to 2017, mostly for cross-border workers—supported by the approval of the "Development law" in 2017. There is evidence, albeit not yet captured by formal statistics, of increasing dynamism of the real economy. Local private investors continue to favor San Marino as their preferred location to do business, as proved by the increasing number of new investment projects.

The Sammarinese authorities broadly concur with the staff's assessment of the economic outlook and related risks, although they see room for growth upsides. They are aware that overcoming the persistent vulnerabilities in the banking sector—while preserving fiscal sustainability—remain an urgent priority to remove impediments to faster growth. However, the authorities intend to act with extreme caution, as San Marino lacks an independent monetary policy and is extremely vulnerable to sudden capital outflows to neighboring Italy in case of a shock.

The authorities remain nevertheless confident that structural reforms – notably further steps to improve the business climate—as well as ongoing infrastructural investments—a 5G telecom network will be ready by the end of 2019—can help attract foreign investments and place the economy on a higher growth path. Structural reforms can also generate a positive effect on the State accounts, thus allowing the State to reimburse the Central Bank of San Marino's (CBSM) loans and restore its reserves.

Besides, economic prospects are expected to receive a boost from the conclusion of the association agreement with the EU—which could be finalized before the end of 2019, as announced at the high-level meeting held on March 5th and 6th in Brussels—and the signing of a Memorandum of Understanding with the Bank of Italy. The authorities intend to accelerate the implementation of the reform agenda defined in the Financial Sector Strategy recommended by the IMF to boost competitiveness and place the economy on a sustainable growth path, thus avoiding the "muddling-through" scenario envisaged by the staff.

Financial Sector

The authorities recognize that delays in acting to repair the banking system endanger financial stability and that strengthening banks' liquidity and capital positions remains an urgent priority. They agree that advancing NPL resolution is critical and that private banks should first attempt to raise capital from private sources. They encourage the finalization of systemic projects aimed at effective NPLs reduction in order to decrease banks' credit risks.

The Government remains committed to supporting the CBSM's role in the comprehensive Financial Sector Strategy aimed at restoring financial stability through banks' recapitalization (following the Asset Quality Review-AQR results), their organizational and governance restructuring and effective NPL reduction. The authorities intend to boost the effectiveness of the Financial Sector Strategy by enhancing the CBSM's supervisory powers and removing legal, regulatory and tax impediments to NPL resolution

The authorities emphasize that the staff's inclusion of tax credits in computing the implicit public debt is a choice that contradicts standard accounting criteria: tax credits technically become public debt only if and when converted into government bonds and this is not the case for San Marino. The staff's projections of the level of the implicit public debt are based on the assumption of public intervention to cover all the financial needs of the banking system, a scenario that the authorities do not consider as being applicable with certainty.

The authorities underscore that the ongoing AQR disclosure process, which will lead to the recapitalization of banks, and the measures adopted by the CBSM to improve the monitoring and management of the liquidity in the banking system are important steps towards restoring its health. Strengthening relations with the Bank of Italy would improve CBSM Supervision and lead to the signing of the Memorandum of Understanding (MoU).

As the main shareholder of Cassa di Risparmio della Repubblica di San Marino (CRSM), the Government is aware of the need to reduce losses, recapitalize and restructure the bank for it to regain its ability to finance the real economy. The authorities broadly agree with the staff's approach on how to address capital shortfalls in the banking system. They also support a faster NPL resolution as a key step to restore long-term viability of banks: to this end, full liberalization of the real estate market and the new legislation to facilitate out-of-court debt restructuring are some of the initiatives already delivered by the Government.

The CBSM highlights the urgency of improved powers and tools to enhance the bank resolution framework in order to effectively deal with failing supervised entities and reduce potential fiscal costs.

The authorities acknowledge the impending need for banks to improve efficiency and restore viability, including by reducing operational costs substantially, including labor costs, and rationalizing the branch network.

The authorities have major concerns on the staff's suggestion to apply burden sharing, including to subordinated debt, due to San Marino's specificities, an enclave in Italy; they also believe that a full guarantee of the Institute of Social Security's (ISS) pension deposits is necessary to boost confidence and relieve liquidity pressures.

San Marino's authorities underscore the transposition of the 4th EU Anti-Money Laundering (AML) Directive into national laws and the strengthening of AML/CFT legal and regulatory frameworks. Following the results of the AML National Risk Assessment and Action Plan, the authorities indicate that they have adopted regulatory measures on sound management in relation to ML/TF risks, which contain provisions related to corporate governance and financial integrity, reiterating the importance of the "tone at the top". The OECD Global Forum, in a recently published peer review report on the Exchange of Information on Request, has upgraded San Marino's overall rating from "Largely Compliant" to "Compliant". To continuously understand and mitigate financial integrity ML/TF risks, the authorities are currently undertaking a second National Risk Assessment, which is planned to be completed by the end of 2019.

Moreover, the EU has removed San Marino from its tax haven gray list, following the updating of the Annex 2 (Fair Taxation—2.1 Existence of harmful regimes) published by the EU Code of Conduct, on 20 December 2018. Among the criteria used by the EU, one is the fact that the minimum standards of the OECD's Base Erosion and Profit Shifting (BEPS) project are being implemented. In 2016 San Marino joined the OECD's new inclusive framework to tackle BEPS. The positive evaluation (as "Not Harmful") obtained in October 2018 during the Forum on Harmful Tax Practices meeting for the Action 5's BEPS peer review, was fundamental for the evaluation by the EU Code of Conduct.

Fiscal Policy

The authorities recognize the need to address the fiscal risks related to banking system repair and concur that growth-friendly fiscal reforms are needed to ensure debt sustainability. They note that, despite the State support to the CRSM, mainly to cover the 2017 loss, the overall fiscal deficit is projected to have narrowed in 2018 by about 1 percentage point—to 2.7 percent of GDP—on the back of adopted one-off measures.

The 2019 budget approved in December 2018 aims at achieving a broadly balanced position, net of government transfers to CRSM. To this end, the budget introduces new measures, which are projected to partly offset the measures expired in 2018.

The authorities agree that an ambitious fiscal adjustment, with measures on both the revenue and expenditure side, is needed to put public debt on a sustainable path and gradually build fiscal buffers. To this end, the authorities plan to replace the single-stage import tax (Monofase) with a value-added tax (VAT) in 2020 as a way to remove distortions and yield additional revenues.

The authorities are finalizing a pension reform that aims at containing transfers to the ISS, safeguarding the pension system's sustainability and achieving budget savings. Elements of this reform include the postponement of the retirement age and the transition to a more sustainable system of pension calculation. The authorities are also developing a wealth indicator for households to facilitate a better targeting of social benefits and strengthen the ISS financial standing. They are conducting a spending review to improve efficiency across government units. In the health sector, which is based on the principle of universal coverage, the introduction of a new approach based on prevention and enhanced monitoring will set health expenditure on a more moderate rising trend.

The authorities also note the challenging political environment and the need to achieve broad agreement with social partners to ensure a successful implementation of indirect taxation and pension reforms.

Structural Reforms

In pursuing the objectives of internationalizing and diversifying the economy, the authorities remain committed to tackling structural impediments to faster growth; they underscore the improvement in San Marino's Doing Business score in recent years and the role played by the Development Law in supporting employment. Further benefits are expected from the recently-established Office for Active Labor Market Policies, which will be instrumental in enhancing training and job searching as well as in better targeting social benefits.

The authorities place a particularly high value on making further progress towards integration with Italy and the EU, which would provide domestic companies with better opportunities to expand market access and operate abroad. To this end, an Economic Development Agency has been recently set up, also with a view to promoting foreign direct investments and tourism. The latter is deemed to be a sector with untapped potential and plans are being prepared to boost hotels' capacity and develop skills.

In the face of tight budget constraints, the authorities have chosen to support higher private investment, including in innovative sectors, by alleviating firms' loan interest payments, expanding tax incentives, reducing red tape, and utilizing public-private partnerships.

The authorities emphasize that important investments have already been made to upgrade infrastructure in telecommunication, which along with improved transportation will help increase the business connectivity with trading partners and promote competitiveness. Further benefits, notably a simplification of the operations of Sammarinese firms abroad, are expected from the conclusion of the Association Agreement with the EU.

Authorities are convinced that San Marino has an unexploited growth potential and intend to accelerate a rapid transformation of its economy. To this purpose, they are actively seeking financial partners that could support infrastructural and innovative projects and contribute as well to an upgrade of the industrial and financial sectors. Discussions are ongoing with several interested parties.

With a view to supporting sustainable and equitable growth in the long term, the Government intends to promote a reflection on the future of the Sammarinese economy that could serve beyond the terms of its mandate. This new initiative will be launched in the coming weeks and will engage the civil society at large, including representatives of the main productive sectors of the economy.

Finally, the authorities would like to once again thank Fund staff for the provision of relevant technical assistance, which has allowed to greatly improve the production of statistics on the balance of payment and International Investment position.