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San Marino: 2004 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for San Marino

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2004 Article IV consultation with San Marino, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 11, 2004, with the officials of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on July 2, 2004. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of July 28, 2004 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its July 28, 2004 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for San Marino.

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

Selected Issues Paper and Statistical Appendix

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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SAN MARINO

Staff Report for the 2004 Article IV Consultation

Prepared by the Staff Representatives for the 2004 Consultation with San Marino

Approved by Alessandro Leipold and Anthony Boote

July 2, 2004

- Consultation discussions: April 29–May 11, 2004
- Staff team: Mr. Prati (head, RES), Mr. Anayiotos and Ms. Sgherri (both EUR). Mr. Lombardi (OED) participated in the meetings.
- The team met with the Ministers of Foreign Affairs, Internal Affairs, Finance, Industry, Public Health and Social Security, Labor, and Tourism. It also met with the President, the Director General, and the Head of the Supervision Division of the Central Bank, as well as representatives of financial institutions, public enterprises, labor unions, the employers' and self-employed associations. There was an audience with the Captains Regent, the co-heads of state.
- In concluding the last Article IV consultation on December 5, 2001,[1] Directors welcomed the authorities' objective to return the budget to balance over the next two years and strengthen banking supervision, but called for ambitious reforms of the pension and health care systems.
- The authorities released the mission's concluding statement and have indicated their intention to publish the staff report.
- Progress has been made, but there are important shortcomings in many parts of San Marino's statistical database. San Marino does not subscribe to the GDDS.

[1] San Marino is on the 24-month consultation cycle. The Executive Board was notified of a delay in the current consultation cycle due to staff constraints.

Contents Page

EXECUTIVE SUMMARY

The economy has slowed considerably since 2000 with the fading of key competitive advantages that had contributed to past rapid development. Returning to a high growth path is feasible but requires decisive fiscal, structural, and financial sector reforms, which the government—supported by a broad parliamentary majority—is well placed to implement.

In the period 2000-2002, average GDP growth decelerated to 2¾ percent from a pace almost three times as high in the 1990s. While this was a better performance than that of contiguous regions, Italy, and the euro area, it trailed behind that of other small European countries. Manufacturing and commerce faltered in the midst of inflexible labor markets, narrowing tax advantages, and greater price competition from nearby areas. In the financial sector, a flurry of new entrants, and the repatriation of Italian deposits on the heels of a tax amnesty, eroded profitability. Against this background, GDP is expected to rise by 2 percent in 2004, after stalling in 2003. Downside risks are related to Italy's new tax on commuters' income and prospective EU-related changes in savings taxation, which may depress employment and deposit growth.

To restore a positive net asset position and the ability to buffer adverse external shocks, the authorities aim at maintaining the budget in balance or in surplus over the medium term, while preserving tax rate advantages—a key determinant of growth in the past. After years of recurrent fiscal deficits, the government achieved a surplus of 1½ percent of GDP in 2003 by containing the public sector wage bill and improving the administration of indirect taxes. This turnaround began improving the net asset position of the central government, which had deteriorated by more than 15 percent of GDP in a decade. To sustain fiscal consolidation with unchanged or lower tax rates, remaining tax administration problems need to be addressed and generous entitlement programs reformed. Population aging and downside risks to employment growth heighten the urgency of a far-reaching pension reform.

To deliver higher growth in the medium term, further labor and product market reforms are needed. Cutbacks in public sector employment and moderate growth in public sector wages have recently improved the functioning of the labor market. To attract foreign investment, remaining hiring restrictions on nonresidents should be eliminated and fixed-term contracts for Sammarinese workers be allowed. Resisting pressures to reintroduce tax exemptions and adhering to the government's stated goal of substituting rules for political discretion in key areas of economic activity would also be important.

To create the conditions for further development of the financial sector while safeguarding its soundness, the authorities should step up efforts to upgrade financial legislation and improve supervisory practices. While Sammarinese banks remain relatively more efficient, better capitalized, and with fewer nonperforming loans than comparators, declining profitability raises risk-taking incentives. Measures needed include increasing the frequency of on-site inspections and transferring the right to grant and revoke licenses to an independent supervisory and regulatory authority. AML/CFT provisions have been strengthened, TA from LEG on financial legislation has been scheduled for 2005, and the authorities have expressed interest in an FSAP.

I. BACKGROUND

1. San Marino is a landlocked republic in central Italy with a population of about 30,000 and an area of 23.5 square miles, which makes it the third-smallest country in Europe after the Vatican City and Monaco (Table 1).

2. **San Marino uses the euro as official currency and operates in a customs union with the European Union**. Inflation and interest rate developments are coupled with those of Italy (Figure 1). Its workforce is very mobile, with Italian commuters accounting for about 35 percent of private sector employment.

3. **In common with many other small cities in the surrounding Italian regions, San Marino has important tourism and commercial sectors, but its manufacturing and financial activities are much larger**. While manufacturing employment is on a declining trend, it still accounts for more than 40 percent of total employment—a share above that of Italy and adjacent areas, and much higher than in other industrial and small countries (Figure 2). The Sammarinese financial sector accounts for only 4 percent of private employment but its salaries and profits are, respectively, 10 and 16 percent of the total (Figure 3). Deposits and managed funds in Sammarinese banks are about ten times GDP against a ratio of two-three times GDP in Italy and neighboring zones (Figure 4). The size of the Sammarinese financial system in percent of GDP is also large by international standards, although the system is smaller than those of, for example, Luxembourg, Andorra, Monaco, Liechtenstein, and the Cayman Islands (Figure 5). In 2003, nonresidents' funds were US$6.6 billion, corresponding to about half of deposits and 60 percent of managed funds. Although these sizeable nonresidents' funds are reminiscent of an Offshore Financial Center (OFC), no internationally compiled list of OFCs includes San Marino.

4. **San Marino faces several policy challenges related to the erosion of competitive advantages and consequent heightened vulnerability to external shocks**:

- While average growth rates since 2000 exceeded those recorded in contiguous regions, Italy, and the euro area, they fell short of those achieved by San Marino in the 1990s and were lower than in other small European countries—such as Luxembourg, Andorra, Cyprus, and Monaco—which expanded rapidly even during the global slowdown (Figure 6). Narrowing tax differentials, greater labor market flexibility in Italy, and new price competition from shopping centers in nearby areas were mostly responsible for the slowdown.

- After a decade of recurrent deficits, the government made major strides toward correcting fiscal imbalances reaching a surplus of 1½ percent of GDP in 2003. However, the problems of poor revenue performance and generous entitlement programs remain largely unaddressed, raising doubts about prospects for a sustained improvement in the government's net financial asset position and its ability to buffer adverse external shocks.

- A reduction of public sector employment from past high levels and a moderate growth in public sector wages have improved the functioning of the labor market in recent years, but these changes risk being reversed and labor market flexibility remains insufficient.

- In the financial sector, increased competition and tax amnesties in Italy—together with prospective changes in EU savings taxation—have moderated growth in nonresidents' accounts and put pressure on profits that may raise risk-taking incentives.

5. **Implementation of past policy advice has generally been positive (Box 1) although political instability delayed the fiscal adjustment and reforms that appeared imminent at the time of the last Board discussion.** Unusual political instability continued after the early elections of June 2001 with four changes in the composition of the governing coalition in less than two years. A new government with a more stable parliamentary majority—including all main parties in Parliament—took charge in December 2003 and is expected to last until the next 2006 elections.

Box 1. San Marino: Policy Recommendations and Implementation

San Marino acceded to Fund membership in 1992 with the aim, among others, of benefitting from the international policy debate and opening up to international scrutiny and advice on best practices. The authorities believe they have benefited both from the Fund's policy recommendations and technical assistance.

Implementation of the Fund's advice has been gradual but ongoing. In the fiscal area, it includes the reduction of the size of the public sector, and the return of the central government budget to balance in 2003. Reforms of the pension and health-care systems are being considered. A strengthened legal framework against money laundering and terrorism financing is in place and bank supervision and regulation is being enhanced.

San Marino has also made recourse to the Fund's technical assistance (TA). Recently, the authorities received a STA multi-sector mission and a STA Monetary and Financial Statistics mission. The authorities have advanced a formal request for TA in GFS compilation, are scheduled to receive TA from LEG on banking and other financial and regulatory legislation, and are expected to request an FSAP.

II. Policy Discussions

6. Against this background, the discussions focused on the short- and medium-term outlook and the fiscal, structural, and financial sector policies that might offset the recent loss of competitive advantages and put San Marino back on a high growth path.

A. Economic Developments and Outlook

7. **After the rapid development of the 1990s with real growth rates averaging 7½ percent per year, growth slowed to a third of that rate in 2000–02**. It is likely to have remained sluggish also in 2003, with the unemployment rate rising above that of neighboring regions for the first time since 1990 (Figures 6 and 7). The slowdown was particularly severe in commerce and tourism (Figure 2, bottom panel), whose contribution to growth turned negative in the wake of intense price competition from surrounding areas and fewer tourists in the Italian resorts on the Adriatic coast. Lower profits of manufacturing and services and cuts in the public sector wage bill led to smaller but still positive contributions to growth of these sectors. By

contrast, the contribution of the financial sector surged thanks to rapid employment growth offsetting lower profit margins.

8. **There is broad agreement, in official and private sector circles, that both permanent and transitory factors have accounted for the weakening of the economy.** Lower corporate tax rates in Italy have narrowed the tax differential that had previously attracted business to San Marino and the spread of fixed-term contracts in Italy has reduced the advantage of the fixed-term contracts with which Sammarinese firms hire Italian commuters. At the same time, a 2002-2003 Italian tax amnesty on undeclared capital held abroad (*scudo fiscale*) resulted in outflows of about €760 million (11 percent of 2001 nonresidents' funds, Figure 4), while languishing Italian consumption has contributed to depress commerce and tourism and the appreciation of the euro has curbed the competitiveness of manufacturing firms.[2]

Box 2. Taxation of Italian Commuters

Italy's 2004 budget law stipulates that, starting January 1, 2004, Italian commuters working in San Marino would pay taxes in Italy after deducting €8,000 from their taxable income and claiming a tax credit for taxes paid in San Marino. This contrasts with the full exemption from Italian income taxes that Italian commuters had enjoyed since 1987. In passing the budget law, the Italian parliament rescinded a preliminary agreement with San Marino according to which Italian commuters could deduct as much as €24,000 from taxable income. By contrast, Italian commuters to Switzerland and the Vatican City are fully exempt from Italian income taxes under bilateral treaties.

9. **Looking forward, the authorities recognized that there were risks associated with upcoming changes in the taxation of income and savings, but downplayed their immediate impact**. In relation to Italy's decision to tax labor income earned in San Marino (Box 2), they indicated that they intended to press Italy to comply with a preliminary agreement granting a higher tax exemption to commuters and to point to the disparity of treatment with Switzerland and the Vatican City. The staff stressed that, if these approaches were unsuccessful, the wage pressures likely to be associated with the introduction of the new tax would erode San Marino's current unit labor cost advantage of about 10 percentage points (Figure 8). Most financial sector representatives agreed with the authorities' assessment that the increase in withholding taxes on interest income foreseen by the agreement with the EU (Box 3) would not trigger an immediate outflow of funds and alternative tax-exempt savings instruments were likely to be developed in the medium term (see Section II.D).

[2] While 90 percent of Sammarinese exports are to Italy, euro appreciation has had an indirect negative effect on those Sammarinese firms that produce intermediate goods for Italian firms exporting outside the euro area.

Box 3. EU Savings Tax

The EU Council of Economic and Finance Ministers (EcoFin) approved in June 2003 a directive (2003/48/EC) aimed at reducing the evasion of capital income taxes. The directive provides that—subject to certain transitional exemptions—EU member states shall **exchange information** to ensure that interest payments are taxed in the state in which the account holder is resident. The directive will come into force not earlier than January 1, 2005 and at least six months after the EcoFin decides its implementation and that: (i) **five non-EU members** (i.e., Switzerland, Andorra, Liechtenstein, Monaco, and San Marino) have agreed with the European Community (EC) to adopt "measures equivalent" to those contained in the directive; and (ii) **the United States** are committed to the exchange of relevant information.

Austria, Belgium, and Luxembourg will receive information from the outset but will provide it only at the end of a seven-year transitional period. During this period, the three countries shall retain their banking secrecy laws but will levy a 15 percent withholding tax on interest payments, rising to 20 percent after 3 years, and to 35 percent after 6 years (although this higher rate might not be reached if some EU countries have lower rates).

The five non-EU members have recently concluded agreements with the EC under similar terms to those of Austria, Belgium, and Luxembourg. Unlike the latter, they can opt out of the automatic exchange of information at the end of the seven-year transitional period by maintaining a 35 percent withholding tax. The EcoFin has approved the implementation of the Savings Tax Directive, although the timing remains uncertain, as a Swiss referendum ratifying this decision could potentially delay the scheme's entry into force.

10. **In the short term, market participants expected an improved global outlook to benefit both Italy and San Marino.** Foreign demand would drive the recovery in manufacturing and tourism, and an upward trend in interest rates would raise the profitability of the banking system. The upturn in employment in the first quarter of 2004 (1.3 percent year-on-year) bodes well for the upcoming recovery.

11. **The authorities recognized that, in the medium term, San Marino needed to adapt to the changed external environment by identifying new sources of growth and improving its capacity to buffer shocks**. Several market participants stressed that further development of the services and financial sectors was of the essence to wean the economy from its dependence on the manufacturing sector, as foreign competition places pressure on the Sammarinese and Italian economies to de-industrialize. To facilitate this transformation and restore the capacity of fiscal policy to react to cyclical downturns and external shocks, the authorities agreed that fiscal consolidation—accompanied by labor market and financial sector reforms—was a priority.

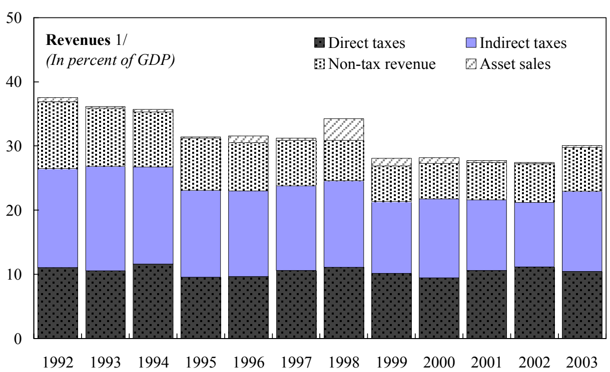
B. Fiscal Policy

12. **Remarkable fiscal adjustment took place in 2003 with the central administration balance moving from a deficit of 2.2 percent in 2002 to a surplus of 1.6 percent of GDP**. This turnaround followed a decade of budget deficits and a large reassessment of past tax arrears in 2001—due to new criteria for assessing the risk of insolvency of taxpayers with overdue taxes—that transformed a slight net asset position into a net liability position of 11 percent of

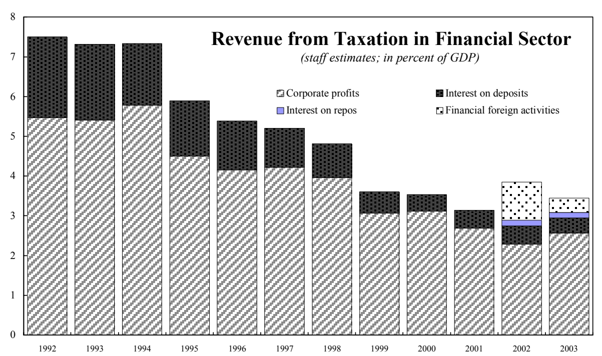
GDP in 2003. To finance the cash deficit, the government ran down its deposits with the banking system and, since the mid 1990s, borrowed short-term (Table 2 and Figure 9).[3]

13. **The reserves of the pension system rose appreciably over the past decade despite pension expenditure systematically exceeding social security contributions** (Figure 10). Although the deficits of the funds of shopkeepers, artisans, and entrepreneurs more than offset the surplus (until 2002) of the dependent workers' fund, reserves reached 13.8 percent of GDP at end-2003 thanks to other revenues (mid panel of Figure 10).

14. **The government aims at ensuring a budget in balance or surplus over the medium term**. The authorities noted that fiscal adjustment was under way—with a better-than-targeted 2003 outcome (the original target was a deficit of 1.6 percent of GDP) and parliament approving a budget close to balance for 2004 and balanced-budget targets for 2005-2006. While the measures that have underpinned the 2003 adjustment (reductions in the public sector wage bill and improved indirect tax administration) are likely to have permanent effects and could lead to a better-than-targeted 2004 outcome,[4] it was agreed that improving the fiscal position on a sustainable basis remained a challenge in view of the remaining shortcomings in tax collection and the generosity of entitlement programs.



1/ Net of tax reimbursements



Source: Sammarinese authorities and Fund staff estimates.
1/ Includes the one-time 2002 tax on foreign financial assets and a 4% withholding tax on interest from foreign-issued bonds.

15. **Staff drew attention to the poor revenue performance as a glaring budget weakness that the 2003 outcome had only begun to remedy** (text figure). Total revenues net of reimbursements fell by about 7½ percent of GDP from 1992 to 2003 reflecting a collapse of non-

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[3] Appendix III presents a debt sustainability analysis. The rising level of debt under historical averages (line A1) reflects a 10-year average of the primary deficit of 2.2 percent of GDP. Maintaining the budget surplus at its 2003 level would allow San Marino to repay its debt by 2006 (line A2). The accounts of individual public enterprises and the methodology for reclassifying the central administration accounts are presented in San Marino―Statistical Appendix and Selected Issues, forthcoming.

[4] In addition, the 2004 budget foresaw a 1 percent of GDP adjustment from the original 2003 target. Tables 1 and 2 show a weakening of the fiscal position in relation to the 2003 outturn because they are based on 2004 budget figures.

tax revenues, a large contraction of the import tax (*monofase* [5])—which accounts for over 90 percent of indirect taxes, and lower direct taxes. Taxes on the financial sector more than halved in the midst of reduced profitability and lower interest rates (text figure).

16. **In response to this worrying revenue trend, the authorities outlined a strategy based on expanding the tax base while trying to preserve tax rate advantages—a key determinant of growth in the past**. They noted that the prolonged downward trend of tax revenues reflected lapses in tax collection and long-lasting effects of past legislative initiatives (e.g., widespread tax exemptions).[6] As a consequence, they had stopped granting new tax exemptions in 2002, changed notification requirements to enhance compliance with property-income tax, and improved estimates of import tax reimbursements. New norms limited the scope for accumulating tax arrears and put the Central Bank in charge of collecting overdue taxes.[7] Staff supported these measures and suggested making them more effective by giving the tax collection agency access to financial information on non-complying taxpayers—a controversial measure that some considered an infringement of banking secrecy—and by reducing the incentives to underreport incomes, linking pension benefits to paid contributions.

17. **In light of its greater concern for the effects of the new tax treatment of Italian commuters on employment, staff stressed that this change cast a shadow on future revenue prospects**. Higher Italian taxes on commuters' incomes were likely to affect San Marino's tax revenues and social security contributions not only by reducing employment and income growth but also by increasing incentives to underreport commuters' salaries.

18. **There was general agreement that the immediate impact on tax revenues of the EU-related withholding tax on nonresidents' interest would be minimal**. Although financial institutions may take some time to devise alternative savings instruments with tax-exempt returns (see Section II.D), they were confident that, in the short run, the first new level of the withholding tax rate (15 percent) would not be so high as to trigger a substantial outflow of funds.. As long as the tax base remains broadly unchanged, San Marino's tax revenues may even increase. While the agreement stipulates that 75 percent of the proceeds from the withholding tax be remitted to the country of residence of the investor, it also provides that any other tax levied on the same income shall be credited against it. This implies that, if San Marino decided to increase all its withholding taxes on interest—currently at 11 percent for bank deposits, 8 percent

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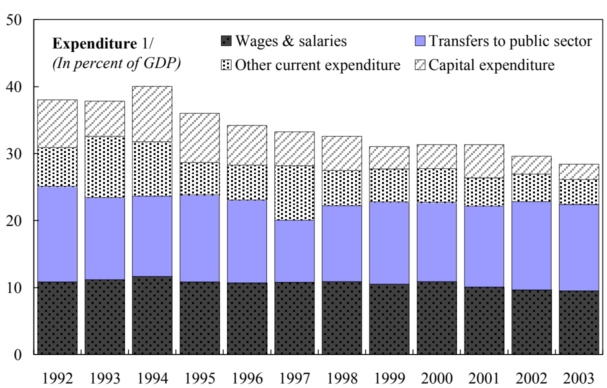
[5] The *monofase* is a single-stage indirect tax that is levied on imports and reimbursed if goods are subsequently re-exported. It replaces the more commonly used VAT. The higher *monofase* proceeds in 2003, which account for most of the improvement in net revenue that year, are mainly due to new procedures for determining the amount of reimbursements.

[6] In 2002, seven percent of manufacturing firms were exempt from taxation with an estimated revenue loss of about 3 percent of GDP. Artisans also benefited from liberal tax exemptions.

[7] While it is clearly unusual for a Central Bank to be in charge of collecting overdue taxes, there was a need to remove this task from undue political interference, which, in the past, had led to a large accumulation of overdue taxes.

for long-term certificates, 4 percent for foreign bonds, and 2 percent for repos—to 15 percent, it could retain all the proceeds from the saving tax. A reason for not following this course of action would be the risk that Sammarinese depositors might then prefer banking in EU countries with lower withholding taxes. However, with the Italian withholding tax rate at 12.5 percent, the tax differential is unlikely to be large enough to bring about an outflow of Sammarinese funds in the short term.

19. **As revenues plummeted during the 1990s, the authorities compressed expenditures—mostly capital expenditure and the public sector wage bill**. Between 1992 and 2003, total expenditures fell by about 9½ percent of GDP (text figure) with lower capital expenditures explaining half of the adjustment. A tight hiring freeze reduced public sector employment in line with that of other small advanced economies (text figure) and contributed, together with responsible wage negotiations and limited use of overtime, to trimming the wage bill by almost 1½ percent of GDP. Current transfers to the public sector fell by a similar amount, also reflecting lower personnel costs in public enterprises and the Social Security Institute (SSI), which is responsible for health and pension expenditure. Staff welcomed the progress in reducing the size of the public sector. It indicated, however, that there was scope for further reductions as average public sector wages remained about 25 percent above those in the private sector.



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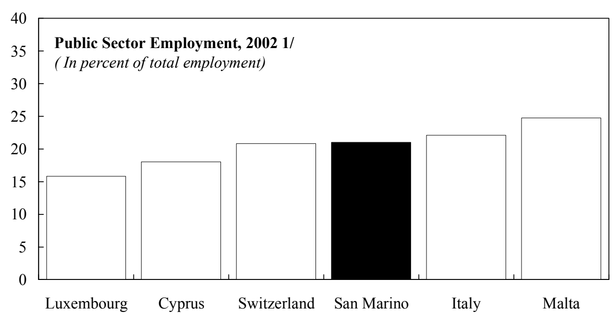
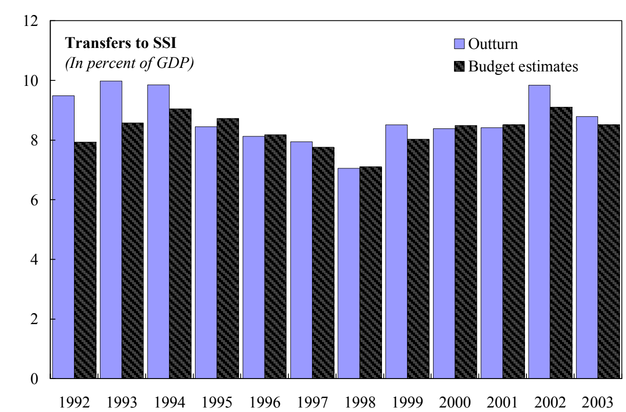
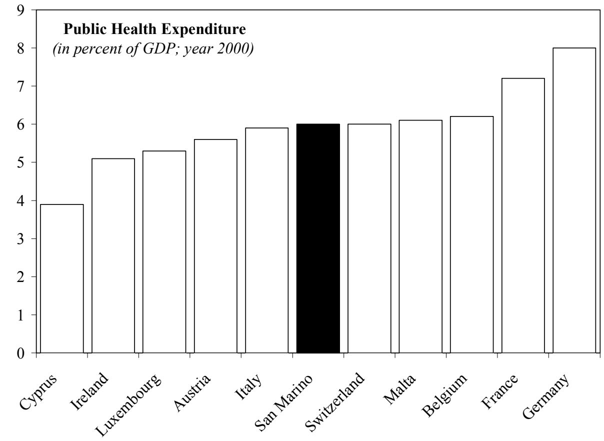


Sources: San Marino's *Ufficio Programmazione Economica e Centro Elaborazione Dati e Statistica*; United Nations, *Statistical Bulletin;* and Fund staff estimates.
1/ Public Administration and Defence; Compulsory Social Security; Education; Health and Social Work.

20. **Staff noted that the reduction in expenditure of the last decade risked giving a misleadingly positive picture of public expenditure control**. Transfers to the SSI have exceeded budget estimates in recent years (text figure). The authorities recognized that it would be difficult to sustain the savings in the medium term without containing public health and pension expenditure.



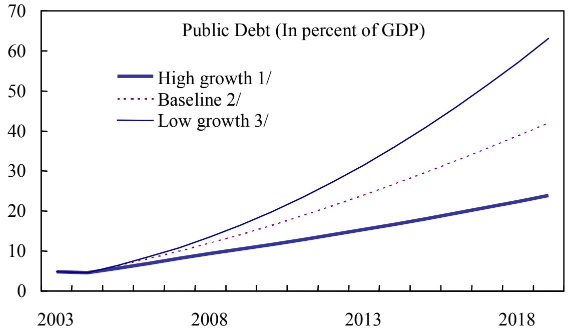
21. **The authorities described several initiatives to pare the costs of the public health system**. Savings on the wage bill of the SSI have stabilized health expenditure in percent of GDP—albeit at a comparatively high level (text figure)—without curtailing public health services. In recent months, the government has renegotiated price conditions with suppliers, and limited the list of pharmaceutical products offered free of charge to the best-price medicines within each category. Since 2003, the budget provides a fixed allocation to the SSI for health expenditure, after years in which it was almost fully financed with *ex-post* budget transfers, while draft legislation institutes an Health Authority and specifies professional requirements for health administrators.

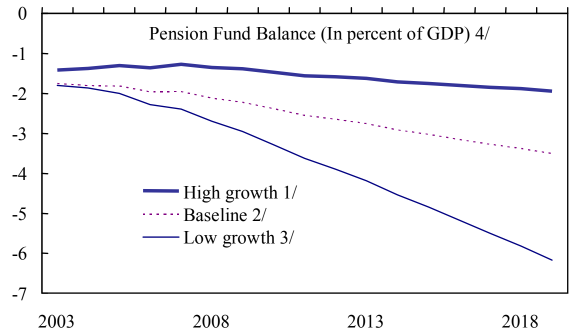


Source: Human Development Indicators 2003.

22. **Staff supported these initiatives but argued that they might not be sufficient to stem the rapidly growing demand for health services**. It observed that using only cost reductions to contain transfers to the SSI could be insufficient and that it might become necessary to introduce co-payments on selected services and pharmaceutical products in the near future. The authorities resisted this suggestion, arguing that they were confident that the ongoing reforms would keep demand pressures under control and expressing skepticism that uniform co-payments could discourage the relatively well-to-do Sammarinese patients from requesting superfluous exams and medications.

23. **Even under past favorable employment trends, generous pension benefits and population aging would require increasing transfers to the SSI over time.** Staff simulations show that, without reforming the pension system, its deficits would lead to a buildup of public debt to between 20 and 65 percent of GDP by 2020 depending on employment growth (text figures). Moreover, prospects of slowing employment growth on the heels of Italy's taxation of commuters' incomes, and of the future likely declining role of labor-intensive manufacturing industries, heighten the urgency of pension reform. At present, transfers from the government and other SSI resources are needed to finance pension expenditure of over 6 percent of GDP and continue accumulating reserves, despite a healthy worker-to-retiree ratio of 4:1 boosting contributions (Figure 10).





1/ Annual labor productivity growth 2 percent; inflation 2 percent; wage growth 4.1 percent; employment growth 3.2 percent; real interest rate 3.4 percent; real GDP growth 5.2 percent.
2/ Annual labor productivity growth 1.1 percent; inflation 2 percent; wage growth 3.1 percent; employment growth 2 percent; real interest rate 3.4 percent; real GDP growth 3.1 percent.
3/ Annual labor productivity growth 0.5 percent; inflation 2 percent; wage growth 2.5 percent; employment growth 0.5 percent; real interest rate 3.4 percent; real GDP growth 1 percent.
4/ Deficits of the pensions funds in the three scenarios are based on " *Pensions and Population Aging* "--Republic of San Marino: Selected Issues and Statistical Appendix, IMF Country Report No. 01/226, December 2001.

24. **In response to the mission's observation that pension reform measures recently approved by Parliament were underwhelming,[8] the authorities indicated that a major reform was in the offing**. The details of the reform plan are yet to be revealed and will be negotiated with the trade unions, the employers' association, and other professional organizations before being presented to parliament. San Marino would introduce a two-pillar system. The first pillar would remain compulsory and pay-as-you-go, but the computation of pension benefits would be linked to lifetime contributions (replicating the system introduced in Italy in 1995) as opposed to the current link to the average of the retiring individuals' reported incomes over the last 5 years (dependent workers) or 10 years (self-employed). The second pillar would be fully-funded. Staff supported the idea of introducing a contribution-based system because it would reduce incentives to underreport incomes that do not count for computing pension benefits. However, it noted that, in previous occasions, the Fund had considered San Marino well placed to introduce a fully-funded system and that the authorities could usefully consider making also the first pillar fully-funded. To finance the closing of the existing pay-as-you-go system, staff suggested reducing the benefits of those workers that were further away from retirement—by raising their effective average retirement age (currently at 60) or introducing equivalent actuarially-fair benefit reductions—and using part of accumulated reserves.

25. **While it was agreed that San Marino would benefit from refinancing high-interest bank loans with the proceeds of a debut Eurobond issue, the staff had reservations about increasing the amount issued to finance infrastructure projects**. The 2004 budget law foresees placing a bond of up to €120 million (about 10 percent of GDP) and up to 10-year maturity. Staff argued that, until tax compliance problems were solved, and without considering

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[8] Parliament increased the retirement age of new workers hired after January 1, 2002, from 60 to 65 and the contribution rate for artisans and shop-owners from 18.5 to 19.5 percent starting January 1, 2003. In the short run, the impact of these changes will be small.

user fees, even projects that stimulated growth might not generate the revenues needed to pay back the debt. Staff also encouraged the government to verify whether renegotiating the high-interest loans with the banking system would not be a lower-cost alternative to bond issuance.

C. Factor and Product Markets

26. **The authorities pointed to several developments and initiatives that have increased the flexibility of the labor market**. First, containing public sector employment and wage growth has not only critically contributed to fiscal adjustment but has also eliminated a long-standing source of wage-drift and loss of competitiveness. Second, the government is trying to remove any presumption that the public sector might resume acting as employer of last resort by reforming the public administration and giving managers autonomy in hiring decisions. Third, a new regulation of nonresidents' hiring speeds up the authorization process while reducing the scope for political interference. The staff supported these measures.

27. **In the face of the higher cost of labor that is likely to result from Italy's new tax on Italian commuters' income earned in San Marino, labor market policies should be geared decisively toward attracting investment**. In this context, staff recommended eliminating remaining hiring restrictions on nonresidents that could discourage expanding or opening businesses in San Marino. Introducing fixed-term contracts matching the flexibility offered by Italian contracts would also help offset a critical advantage that neighboring regions now offer. The authorities indicated that they were ready to consider their introduction only after an experimental phase, planned to start shortly.

28. **The staff welcomed the law stopping new tax exemptions since 2002 and encouraged the authorities to continue reducing state intervention in the economy**. To foster economic efficiency and minimize budgetary outlays, staff stressed the need to limit also subsidized credit, which cost about 0.5 percent of GDP in 2001. The authorities emphasized their goal of replacing the current political discretion with clear and transparent rules in key areas of economic activity ranging from licensing new businesses to managing the public health system.

D. Financial Sector

29. **Banks' profitability suffered a setback in 2001-03 reflecting increased competition from new entrants and a decrease in managed funds due to the Italian "*scudo fiscale*"** (Figures 4 and 11). In contrast to the declining number of banks in the euro zone and Italy, the number of banks operating in San Marino has increased from 4 in 2000 to 10 in 2003, with two more about to open, following a less restrictive licensing policy.[9] About forty non-bank financial intermediaries have started operations over the last three years. Given that Sammarinese financial institutions cannot open branches abroad—particularly in Italy—until the supervisory and regulatory framework is brought in line with EU requirements, they have all been competing in the local market, squeezing profits. In addition, as Italian investors repatriated funds in the

[9] The owners of these new banks are all Sammarinese. At present, only two of the original four banks have a foreign (Italian) ownership.

wake of the "*scudo fiscale*", income from commissions and fees dropped. Sammarinese banks remain, however, relatively more efficient, better capitalized, and with fewer non-performing loans than comparators (Figures 12-13). The authorities also indicated that the exposure of the Sammarinese banking system to Parmalat was negligible.

30. **Market participants concurred that the heightened competitive environment had enhanced the number and quality of services offered but that declining profitability was bound to raise risk-taking incentives**. They agreed, however, that the small loan portfolios and limited trading activity of Sammarinese institutions did not leave much scope, at the moment, for taking risky positions that could endanger their solvency. Most financial sector representatives saw greater potential risks in underperforming institutions possibly accepting deposits or funds under management from "dubious" clients. To safeguard against these vulnerabilities—in accordance with FATF recommendations—staff emphasized that it was essential that "know-your-customer" measures be implemented with particular attention and vigor.

31. **The authorities and most financial sector representatives were confident that a withholding tax on interest income of 15 percent—entailed by the agreement with the EU—would not cause a significant outflow of funds**. The further increase of the tax up to 35 percent by 2010 would have a greater impact but by then the Sammarinese financial system was expected to devise savings instruments with tax-exempt returns. The scope of the directive is also deemed to be limited, as it concerns only private individuals and certain categories of savings products. For example, only interest payments shall be subject to the exchange of information or the withholding tax, whereas income from share dividends, unit trusts, pension funds, or insurance policies shall be excluded. The agreement with the EU on the taxation of savings will also remove a significant element of uncertainty that has been hanging over the Sammarinese financial system, reassuring investors that banking secrecy laws will be retained.

32. **There was agreement that San Marino needed to revamp the financial sector's legislative and regulatory framework and improve supervisory practices**. The government saw the formation of the Central Bank of San Marino (CBSM) as an essential building block of its financial sector strategy and was committed to a quick approval of the Central Bank law, following the July 2003 operational merger law of the *Istituto di Credito Sammarinese* (ICS)—the former central bank—and the Office of Bank Supervision (OBS). The staff argued that this law—besides meshing the banking and supervision divisions of the CBSM effectively—should grant adequate supervisory and regulatory powers to the CBSM. In addition, it should, in line with international best practices, establish a governance structure that ensures its operational independence from the government and the banking sector, a stable source of financing, and clear lines of accountability to Parliament. To address the conflict of interest arising from the fact that commercial banks held a share of ICS's—and thus now of CBSM's—capital, the law is expected to stipulate that the banks will be deprived of the associated voting rights and have no representatives in the CBSM's Board. Staff encouraged the government to take this opportunity to accord the right to grant and revoke licenses to the supervisory authority, as is a matter of course in several other countries. The existing law accords this authority to the government, with the CBSM providing only a non-binding opinion. The staff questioned the capacity of the CBSM to act as lender-of-last-resort and manage and administer deposit insurance because the small size of the CBSM's balance sheet, and of the government budget, in relation to bank deposits could prevent the CBSM from carrying out these functions, which are not as critical as in other

banking systems in view of the higher capitalization and liquidity of assets of Sammarinese banks. While some officials agreed with this assessment, it remained unclear whether the upcoming law will limit the CBSM's functions accordingly.

33. **To maintain the competitiveness of the Sammarinese financial system and to create the conditions for its safe expansion as past tax advantages wither, the authorities pointed to stepped-up efforts to upgrade the regulatory and legislative framework**. The CBSM is increasing its supervisory staff—to be doubled by end-2004—and is setting up a credit registry. In March 2003, San Marino adopted the "1988 Capital Accord" of the Basel Committee on Banking Supervision (Basel I) and has since issued the regulations implementing the related capital adequacy requirements, while the regulations on market risk and derivatives remain to be issued. A new law will introduce mutual funds to be registered in San Marino. The authorities will receive technical assistance on banking and other financial and regulatory legislation from LEG and agreed with the staff that they should undertake a Financial Sector Assessment Program (FSAP) at the earliest opportunity to assess their supervisory structures. Parliament has recently approved new AML/CFT provisions to bring San Marino further into line with international standards, while the authorities completed the Fund questionnaire on the current status of efforts to combat money laundering and terrorism financing.[10]

34. **Staff stressed the importance of improving supervisory practices**. Current practices based on frequent exchanges of information and advice have established a climate of mutual trust between the supervisory authority and the Sammarinese financial institutions and have served San Marino well, potentially contributing to its appeal as a financial center. Staff saw a need, however, to supplement this approach with more frequent on-site inspections, especially given the recent proliferation of banks and non-bank financial institutions which had made it more difficult for supervisors to rely exclusively on personal contacts and data reporting. Furthermore, the evolution and practice of financial sector supervision and regulation in San Marino could benefit from best practices prevailing in other small financial centers.[11]

E. Statistical Issues

35. **While several initiatives to improve the statistical database were underway and the authorities emphasized their objective of increasing the transparency of the fiscal accounts,**

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[10] San Marino is a member of the MONEYVAL Committee of the Council of Europe, a FATF-style regional body, and as such committed to mutual evaluations in anti-money laundering matters. This committee evaluated San Marino in February 2000 and again in March 2003 to verify implementation of the recommendations of the first evaluation and additional criteria later introduced. San Marino responded to FATF Eight Special Recommendations and Questionnaires on Terrorist Financing. In view of its membership in MONEYVAL, the AML/CFT assessment of an FSAP may be carried out by MONEYVAL on the basis of the common AML/CFT methodology.

[11] See "Financial Sector Developments and Prospects—The Role of Regulation and Supervision" in the Republic of San Marino—Selected Issues, forthcoming.

there was agreement that statistical deficiencies continued to hamper effective economic policy formulation. The Statistical Office is making some notable efforts to collect indicators on current economic conditions (e.g., electricity consumption) but there is still a delay of 1½ years in the release of national accounts. The ongoing compilation of a set of experimental consolidated accounts for the public sector according to GFS methodology for 2002 is an important endeavor that would result—in line with the authorities' commitment at the time of the 2001 Board meeting—in a full set of public sector accounts consistent with Eurostat's ESA95 standards. Until these consolidated data are produced on a regular and timely basis, however, fiscal accounts remain nontransparent and require substantial reclassifications.[12] In line with the recommendations of the February 2004 STA TA mission on monetary and financial statistics—which led to the publication of a country page for San Marino in the June 2004 issue of IFS—the staff encouraged the CBSM to: (i) compile and disseminate monthly monetary and financial data, and, in particular, a broad money survey; and (ii) carry out a Financial Soundness Indicators (FSI) self-assessment, moving toward frequent and timely reporting of FSIs. The authorities also expressed interest in participating in the GDDS and requested technical assistance to prepare metadata.

F. Other Issues

36. **Sammarinese financial institutions have no exposure in foreign currency**. Banks' clients have negligible amounts of foreign-currency credit lines (4 percent of loans) and deposits (less than 2 percent of total deposits) for operational purposes.

37. In 2003, San Marino's **official development assistance (ODA)** was less than 0.01 percent of GDP.

III. Staff Appraisal

38. **After the exceptional performance of the 1990s, growth has slowed since 2000 and San Marino now faces new and more testing conditions**. It can reform its economy, offset the recent loss of competitive advantages with efficiency gains and, building on its several strengths, lay the groundwork for returning to a high growth path. Alternatively, without reforms, the erosion of its competitiveness will continue, vulnerability to external shocks will be heightened, and its growth rates will tend to converge toward those of neighboring areas.

39. **While relatively protracted political uncertainty has delayed the required policy response, the new government is rising to the occasion**. It has committed to implement an ambitious reform agenda and is actively negotiating a series of international agreements. The improved short-term outlook creates the conditions for persevering resolutely with this course. Returning to a high-growth path will, however, require concerted action in several areas.

40. **After the decisive fiscal correction of 2003, a budget surplus will need to be maintained until the net financial position of the central administration turns positive and long-standing fiscal problems are resolved**. Reductions in the public sector wage bill—so far

[12] See San Marino—Statistical Appendix and Selected Issues, forthcoming.

the cornerstone of the government's fiscal strategy—are welcome and will need to be supplemented with significant improvements in tax administration and a scaling back of generous entitlement programs. The 2004 budget takes important but insufficient steps in this direction. The tax collection agency should have more information on non-complying taxpayers and, while recent administrative measures have stabilized health expenditure in relation to GDP, the government should stand ready to introduce monetary disincentives if these steps fail to curb the growing demand for health services.

41. **Pension reform needs to be far-reaching**. The reserves of the pension system and past employment growth should not lull the public into a false sense of security. Even if past high employment growth rates continued, generous benefits and population aging will endanger the long-term solvency of the system. The predominantly downside risks to the employment outlook imply that pension reform should not be postponed further, and the broad Parliamentary majority of the government creates a window of opportunity. A comprehensive reform should link pensions to social security contributions over the entire working life, thus reducing incentives to underreport incomes and improving the balance of those pension funds that have been in deficit for years.

42. **San Marino could consider using its substantial pension reserves to smooth the transition from a pay-as-you-go to a fully-funded system**. Reducing pension benefits and raising the effective average retirement age would also be needed to finance the closing down of the pay-as-you-go system. San Marino should eschew, however, depleting the reserves to prolong unduly the generous benefits of the current system.

43. **There is a need to continue reforming labor and product markets.** The priority is to eliminate bureaucratic hindrances and reduce state interventions that stunt business activity. The government has made considerable progress by rolling back the public sector wage bill; appropriately-designed welfare programs—rather than forced hires that reduce the efficiency of public enterprises and the central government—should take care of the unemployed. Much remains to be done, however, including introducing fixed-term labor contracts for Sammarinese workers, liberalizing further nonresidents' hiring, streamlining the bureaucracy, and speeding up administrative procedures.

44. **Resolute pursuit of the government's stated goal of substituting rules for political discretion in key areas of economic activity would also be of significant import**. Extending this approach to banks and nonbank financial institutions—whose licenses should be granted and revoked by an independent supervisory authority—would underscore the change in policy and enhance the attractiveness of San Marino as a financial center.

45. **The authorities should create the conditions for a further development of the financial sector while safeguarding its soundness.** This sector is at a turning point. It might slim down to a level commensurate to the needs of the local economy—as international pressures curtail tax incentives for nonresidents to invest in San Marino. Or it can reach the size typical of a full-fledged financial center, able to attract substantial funds because of its efficiency, the range of services offered, modern financial legislation, and a nimble supervisory and regulatory agency ensuring the stability of the system without imposing an excessive burden. In this scenario, the

contribution to income growth of the financial sector could rise to the level prevailing in other small financial centers.

46. **The regulatory and legislative framework of the financial sector should be enhanced to allow Sammarinese institutions to extend the scope of their activity outside San Marino**. In this context, the ongoing adoption of Basel I—to be completed as early as possible with the issuance of market risk and derivatives regulations—and the intention to undertake an FSAP are welcome.

47. **The supervisory authority needs to gear up for the broader range of services and products that Sammarinese financial institutions will offer.** As the government introduces new legislation on insurance, mutual and pension funds, and other financial sector products or activities, the CBSM should stand ready to provide technical support and professional supervisors. The objective should be to create the conditions for Sammarinese institutions to compete on an equal footing with those operating in Italy and other small financial centers.

48. **In the meantime, the CBSM should remain vigilant and apply the highest supervisory standards**. The key challenge is preventing losses of reputation and outflows of funds that a scandal or financial problem—even in a small institution—would trigger. There is a need to guard against the possibility of excessive risk-taking as profits wither under intense competitive pressure, following the sharp increase in licenses to banks and nonbank financial institutions. Supervisors should adapt their practice to this new environment by increasing the frequency of on-site inspections while the small size of San Marino would allow to continue keeping the supervisory and regulatory burden to a minimum.

49. **San Marino's statistical database has improved but serious shortcomings remain.** The availability of reliable statistics on current economic conditions and up-to-date transparent government accounts is not only important to external observers but is key to designing appropriate economic policies and preparing realistic budgets. Despite its size, San Marino has the resources necessary to devote additional efforts to the compilation of general government accounts in line with Eurostat's ESA95 methodology and timely national account statistics, as well as the collection of indicators enabling estimates of GDP growth. The authorities should also assign clear responsibilities to ensure the consistency of the data published by the Ministry of Finance and the CBSM.

50. San Marino is urged to move toward providing **ODA** in line with the UN-recommended target (0.7 percent of GNP).

51. It is proposed that the next Article IV consultation be held on a 24-month cycle.

Table 1. San Marino: Basic Data, 1996-2004

Total area (sq. km.):	61.2
Population (December 2003):	29,241
GNP per capita (current US$, 2002):	34,902
Life expectancy (2000):	77 (male)
	84 (female)
Infant mortality (2002):	4 per thousand

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Output and Prices									
Real GDP 1/	4.9	6.9	7.5	9.0	2.2	5.5	0.3	0.0	2.0
Employment	2.6	3.3	4.3	4.5	2.8	5.8	3.1	0.8	1.8
Unemployment rate (end of year)	4.9	4.2	4.0	3.2	3.0	2.4	3.9	4.5	2.9
Inflation rate (annual average)	4.9	2.0	1.8	1.6	2.6	2.8	2.3	2.5	2.1
Wages	9.3	5.0	4.2	3.9	1.9	-0.5	3.7	5.7	...
External Accounts 2/									
Trade balance (in millions of US$)	22.6	-27.0	-12.2	-21.1	-44.6	-38.0	-100.9	...	...
Exports 3/	218.7	234.6	202.4	197.4	193.8	186.8	177.6	...	...
Imports 3/	215.8	238.3	203.8	200.0	199.5	191.5	187.9	...	...
Number of tourists (in millions)	3.3	3.3	3.3	3.1	3.1	3.0	3.1	2.8	2.6
(Percent change)	-0.7	-1.1	-1.3	-3.6	-2.5	-1.2	2.2	-8.3	-7.1
Average length of visit (in days)	1.3	2.1	1.5	1.5	1.4	1.6	1.5	1.5	1.5
US$ exchange rate (end of period) 4/	1,530.57	1,759.19	1,653.10	0.995	1.075	1.135	0.954	0.884	0.812
Nominal effective exchange rate index (Italy) 5/	75.59	75.8	76.0	74.1	70.7	71.2	72.1	75.3	76.6
Real effective exchange rate index (Italy) 5/	84.77	85.2	85.9	84.1	80.7	81.7	83.5	88.1	89.8
Fiscal variables 3/ 6/									
Central government net revenue	31.5	31.2	34.2	28.1	28.2	27.7	27.4	30.1	27.3
Central government net expenditure	34.2	33.2	32.6	31.0	31.3	31.3	29.6	28.4	27.8
Central government balance	-2.7	-2.0	1.7	-3.0	-3.2	-3.6	-2.2	1.6	-0.6
Central government deposits	16.0	13.1	8.4	10.8	2.2	0.0	5.2	6.2	6.0
Gross public debt	3.7	4.0	4.1	3.9	4.3	5.5	5.3	4.9	5.3
Interest rates 7/									
Loans	14.5	11.4	9.5	7.9	9.2	8.8	8.0	7.1	...
Repurchase agreements	7.6	5.9	4.3	2.6	3.9	4.0	3.9	2.0	...
Time deposits	6.2	4.7	3.7	2.5	2.6	2.9	2.7	1.6	...
Italian lending rate	12.1	9.7	7.9	5.6	6.3	6.5	5.8	4.8	...
Net foreign assets 3/ 7/									
Deposit money banks	81.6	80.8	63.7	70.6	55.1	51.6	130.0	106.8	...
Central bank 8/	26.8	24.0	19.2	17.1	16.5	14.5	16.0	19.9	...
Fitch IBCA country rating 9/					AA				

Sources: Sammarinese authorities; and Fund staff estimates. Data for 2003-04 are Fund staff estimates and projections.

1/ Fund staff estimate for 2003 and 2004.
2/ Based on national account data.
3/ In percent of GDP.
4/ Lira per US$ up to 1998 and euro per US$ thereafter.
5/ Annual average.
6/ Accrual basis. Budget figures for 2004 and preliminary outturn for 2003.
7/ End of period.
8/ The central bank (CBSM) has no foreign liabilities.
9/ Long-term, foreign currency rating. Italy's Fitch IBCA rating is AA-.

Table 2. San Marino: Central Administration Operations, Accrual Basis, 1992-2004

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003 Preliminary	2004 Budget
							(Million of euros)						
Revenues 1/	143.9	157.2	172.4	174.8	191.2	206.4	247.7	224.7	236.6	252.6	256.4	288.0	271.9
Tax	101.5	116.5	129.2	128.3	139.5	157.1	177.8	170.9	182.5	196.7	198.2	219.7	208.8
Direct 1/	42.4	45.9	56.0	53.2	58.6	70.0	80.2	81.3	79.2	96.7	104.1	100.0	101.1
Import Tax 1/	49.3	61.0	61.4	62.8	68.9	74.4	84.9	74.5	87.3	82.3	71.8	94.9	86.3
Other indirect taxes	9.8	9.7	11.8	12.2	12.0	12.7	12.7	15.2	15.9	17.7	22.3	24.9	21.4
Non-Tax 1/ 2/	40.0	39.4	41.2	45.3	45.4	47.0	45.4	44.5	46.6	53.2	56.5	65.7	59.7
Asset Sales	2.3	1.2	2.0	1.2	6.3	2.3	24.5	9.3	7.5	2.7	1.7	2.6	3.5
Expenditure 1/	145.8	164.3	193.3	200.2	207.4	219.6	235.5	248.7	265.7	285.3	276.8	272.4	277.6
Current expenditure	118.5	141.5	153.3	159.6	171.6	186.3	198.8	221.9	235.6	240.2	251.9	250.6	254.2
Wages & Salaries	41.6	48.7	56.3	60.4	64.9	71.4	79.0	84.4	91.6	91.9	90.5	91.2	91.7
Transfers to Public Sector	54.7	53.3	57.9	72.2	75.0	61.3	81.8	98.1	99.4	109.9	123.0	123.7	115.7
o/w ISS	36.4	43.4	47.6	47.0	49.3	52.5	51.0	68.2	70.4	76.6	92.0	84.3	77.0
Transfers to Private Sector	...	...	...	6.7	6.8	7.9	8.8	8.4	8.9	6.3	9.7	8.0	7.6
Interest Payments	...	...	...	1.5	1.9	2.6	3.4	2.8	2.5	2.4	2.4	2.2	2.9
Others 3/	22.2	39.5	39.2	18.8	23.0	43.2	25.8	28.3	33.2	29.8	26.4	25.5	36.4
Capital expenditure	27.3	22.8	40.0	40.7	35.8	33.3	36.8	26.7	30.1	45.1	24.9	21.8	23.3
Transfers to Public Sector	12.1	10.3	10.3	10.4	13.7	14.8	12.7	11.2	15.0	12.7	3.1	7.9	6.1
Others	15.2	12.6	29.7	30.3	22.1	18.5	24.0	15.5	15.0	32.4	21.8	13.9	17.2
Balance	-2.0	-7.2	-20.8	-25.4	-16.2	-13.2	12.2	-23.9	-29.0	-32.7	-20.4	15.7	-5.6
Financing	2.0	7.2	20.8	25.4	16.2	13.2	-12.2	23.9	29.0	32.7	20.4	-15.7	5.6
Net Debt Financing	-0.2	2.3	0.1	1.8	4.8	4.0	3.4	1.6	4.9	13.8	-1.0	-2.2	5.6
Change in Deposits	-18.7	-3.5	1.7	-18.1	19.5	10.5	26.2	-26.1	68.5	17.9	-48.1	-11.4	0.0
Change in Net Government Arrears	20.9	8.3	19.0	41.7	-8.2	-1.2	-41.8	48.4	-44.3	1.0	69.6	-2.1	0.0
Memorandum Items:													
Tax reimbursements	59.4	66.2	82.5	108.4	158.4	188.4	183.9	236.3	180.6	224.4	216.4	226.5	251.1
Reassessment of old arrears	1.2	3.4	3.4	44.7	12.1	27.0	-14.9	13.6	3.7	-80.1	15.9	1.5	0.0
							(Percent of GDP)						
Revenues 1/	37.5	36.2	35.7	31.4	31.5	31.2	34.2	28.1	28.2	27.7	27.4	30.1	27.3
Tax	26.5	26.8	26.8	23.1	23.0	23.8	24.6	21.3	21.7	21.6	21.2	22.9	20.9
Direct 1/	11.1	10.6	11.6	9.6	9.7	10.6	11.1	10.2	9.4	10.6	11.1	10.4	10.1
Import Tax 1/	12.9	14.0	12.7	11.3	11.4	11.3	11.7	9.3	10.4	9.0	7.7	9.9	8.6
Other indirect taxes	2.6	2.2	2.4	2.2	2.0	1.9	1.8	1.9	1.9	1.9	2.4	2.6	2.1
Non-Tax 1/ 2/	10.4	9.1	8.5	8.1	7.5	7.1	6.3	5.6	5.6	5.8	6.0	6.9	6.0
Asset Sales	0.6	0.3	0.4	0.2	1.0	0.3	3.4	1.2	0.9	0.3	0.2	0.3	0.4
Expenditure 1/	38.0	37.8	40.0	36.0	34.2	33.2	32.6	31.0	31.6	31.3	29.6	28.4	27.8
Current expenditure	30.9	32.6	31.8	28.7	28.3	28.2	27.5	27.7	28.1	26.4	26.9	26.1	25.5
Wages & Salaries	10.9	11.2	11.7	10.9	10.7	10.8	10.9	10.5	10.9	10.1	9.7	9.5	9.2
Transfers to Public Sector	14.3	12.3	12.0	13.0	12.4	9.3	11.3	12.3	11.8	12.1	13.2	12.9	11.6
o/w ISS	9.5	10.0	9.8	8.5	8.1	7.9	7.1	8.5	8.4	8.4	9.8	8.8	7.7
Transfers to Private Sector	...	...	...	1.2	1.1	1.2	1.2	1.0	1.1	0.7	1.0	0.8	0.8
Interest Payments	...	...	...	0.3	0.3	0.4	0.5	0.3	0.3	0.3	0.3	0.2	0.3
Others 3/	5.8	9.1	8.1	3.4	3.8	6.5	3.6	3.5	4.0	3.3	2.8	2.7	3.7
Capital expenditure	7.1	5.3	8.3	7.3	5.9	5.0	5.1	3.3	3.6	4.9	2.7	2.3	2.3
Transfers to Public Sector	3.2	2.4	2.1	1.9	2.3	2.2	1.8	1.4	1.8	1.4	0.3	0.8	0.6
Others	4.0	2.9	6.1	5.4	3.6	2.8	3.3	1.9	1.8	3.6	2.3	1.5	1.7
Balance	-0.5	-1.7	-4.3	-4.6	-2.7	-2.0	1.7	-3.0	-3.5	-3.6	-2.2	1.6	-0.6
Financing	0.5	1.7	4.3	4.6	2.7	2.0	-1.7	3.0	3.5	3.6	2.2	-1.6	0.6
Net Debt Financing	-0.1	0.5	0.0	0.3	0.8	0.6	0.5	0.2	0.6	1.5	-0.1	-0.2	0.6
Change in Deposits	-4.9	-0.8	0.4	-3.3	3.2	1.6	3.6	-3.3	8.2	2.0	-5.1	-1.2	0.0
Change in Net Government Arrears	5.4	1.9	3.9	7.5	-1.3	-0.2	-5.8	6.0	-5.3	0.1	7.4	-0.2	0.0
Memorandum Items:													
Tax reimbursements	15.5	15.2	17.1	19.5	26.1	28.5	25.4	29.5	21.5	24.6	23.1	23.6	25.2
Reassessment of old arrears	0.3	0.8	0.7	8.0	2.0	4.1	-2.1	1.7	0.4	-8.8	1.7	0.2	0.0

Sources: Department of Budget and Planning, *Relazione Previsionale e Programmatica* ; and Fund staff estimates.

1/ Net of tax reimbursements.

2/ Includes custom duties, state monopolies, other special revenues, revenues from financial assets, interests on credits and deposits.

3/ Includes purchases of goods and services, remunerations for consultancies, contribution to interest payments on publicly subsidized loans, and transport costs.

Table 3. San Marino: Indicators of External and Financial Vulnerability, 1998-2003 1/

	1998	1999	2000	2001	2002	2003
Financial Sector Risk Indicators						
Risk-based capital asset ratio 2/	35.0	47.8	46.4	42.4	44.7	35.8
Profits of the banking sector (in millions of U.S. dollars)	105.0	81.6	88.7	45.3	53.9	62.8
Rate of return on average equity						
banking sector 3/	5.1	4.9	5.0	4.4	4.1	4.1
Loan /deposit ratio	25.4	23.3	27.0	27.3	34.3	39.7
Non-performing loans/total loans	1.6	1.4	1.1	1.3	1.1	1.1
Loan Loss Provision / Net Interest Revenue	6.7	8.6	8.8	7.5	7.8	...
Foreign assets of the banking sector (in billions of euros, eop) 3/	3.7	4.4	4.6	5.1	4.6	4.4
Foreign liabilities of the banking sector (in billions of euros, eop) 3/	3.3	3.9	4.1	4.5	3.3	3.4
Cost-income ratio of the banking system	19.4	23.2	22.7	29.3	31.2	29.7

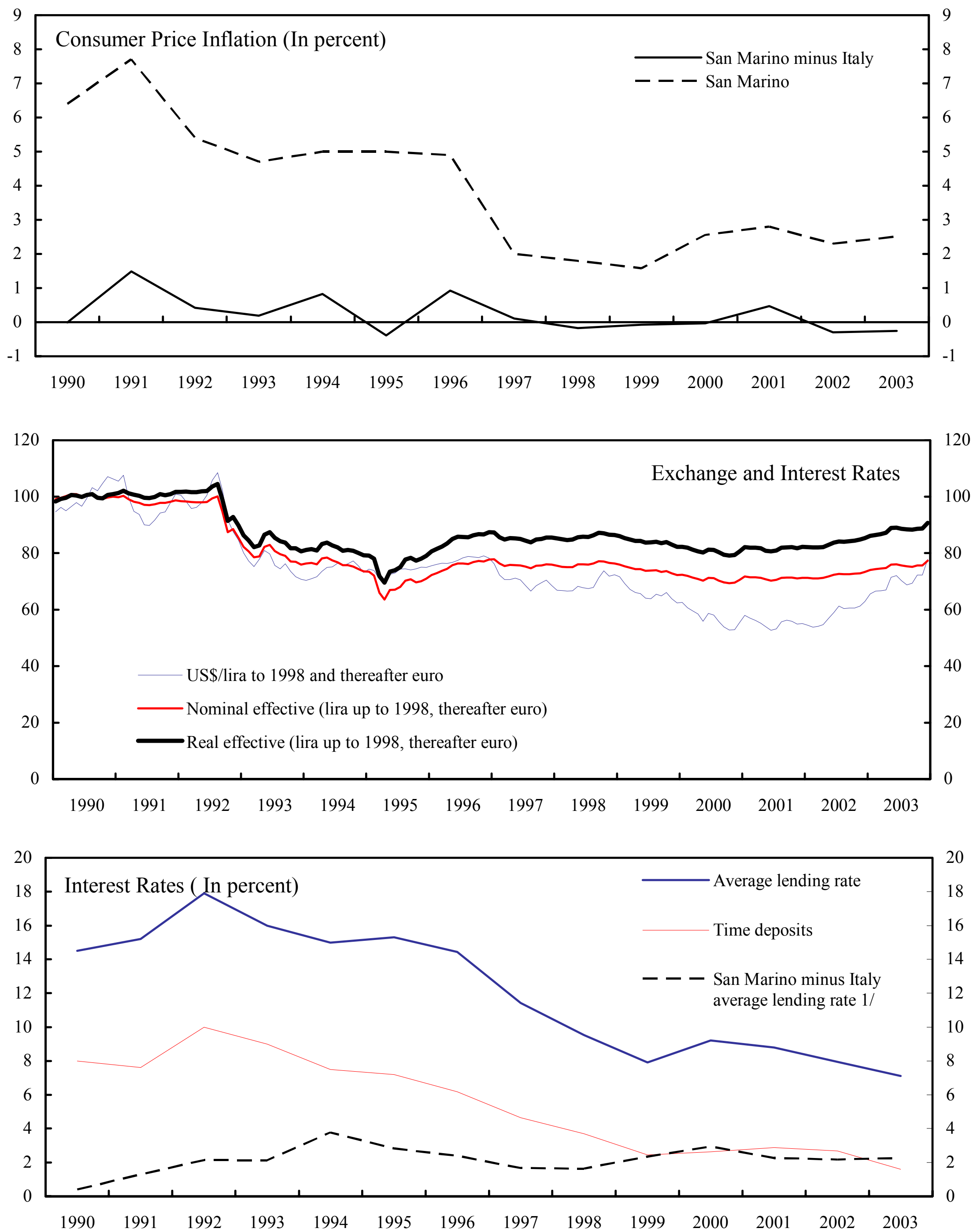
Sources: Sammarinese authorities; Bankscope; IMF, *International Financial Statistics;* and IMF Research department.

1/ The interpretation of some of the indicators is affected by the launch of the EMU in 1999.

2/ On a consolidated basis and after distribution of profits.

3/ Banking institutions.

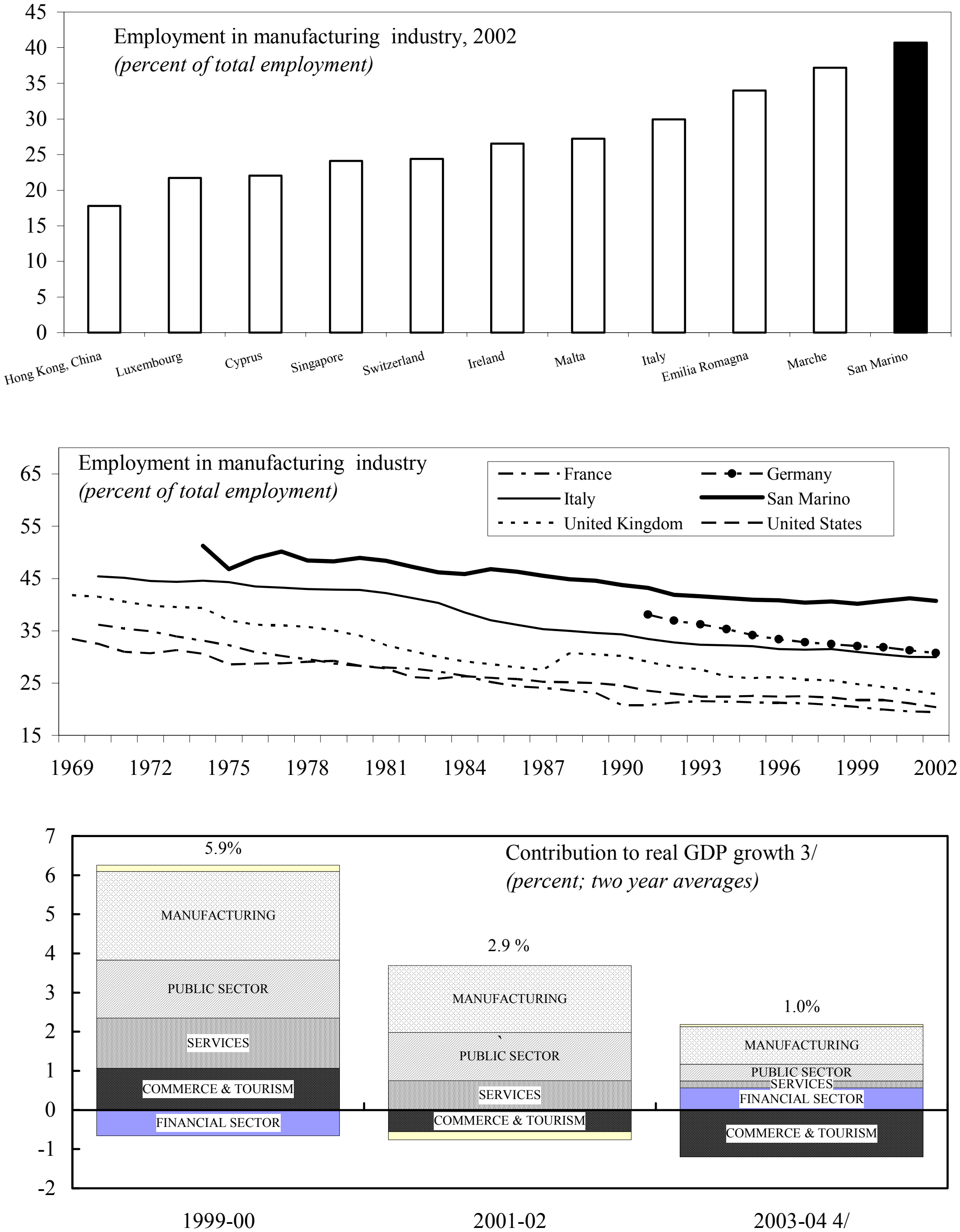
Figure 1. San Marino: Inflation, Exchange Rates and Interest Rates, 1990-2003



Sources: Sammarinese authorities; ISTAT; Bank of Italy; IMF, *Information Notice System;* and Fund staff estimates.

1/ The smaller size of Sammarinese firms in relation to Italian firms explains the stable positive spread between lending rates.

Figure 2. San Marino: Contribution of Manufacturing to the Economy 1/ 2/

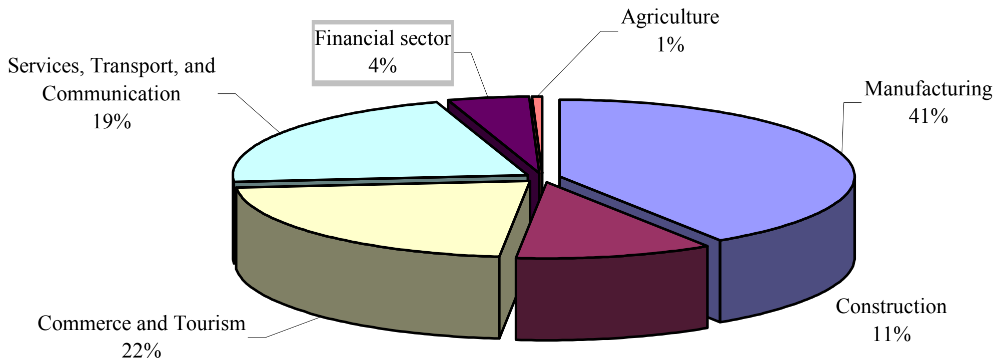


Sources: International Labor Organization (ILO); Sammarinese authorities; SVIMEZ; ISTAT; and Fund staff estimates.

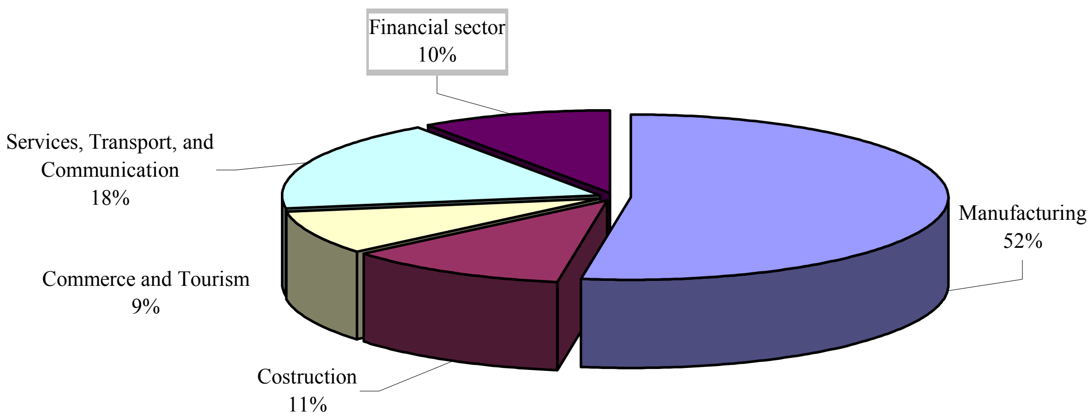
1/ Data for 2003-04 are Fund staff estimates.
2/ Manufacturing includes construction.
3/ Other sectors (not labeled) include agriculture, transport and communication.
4/ Fund staff estimates.

Figure 3. San Marino: Contribution of the Financial Sector to Private Sector Employment, Income and Profits, 2003

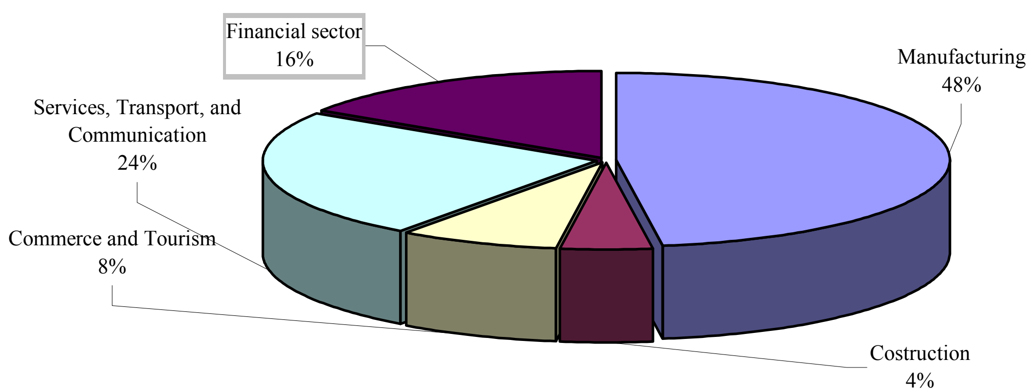
Breakdown of Private Sector Employment by Economic Activity



Breakdown of Private Sector Dependent Labor Income by Economic Activity.

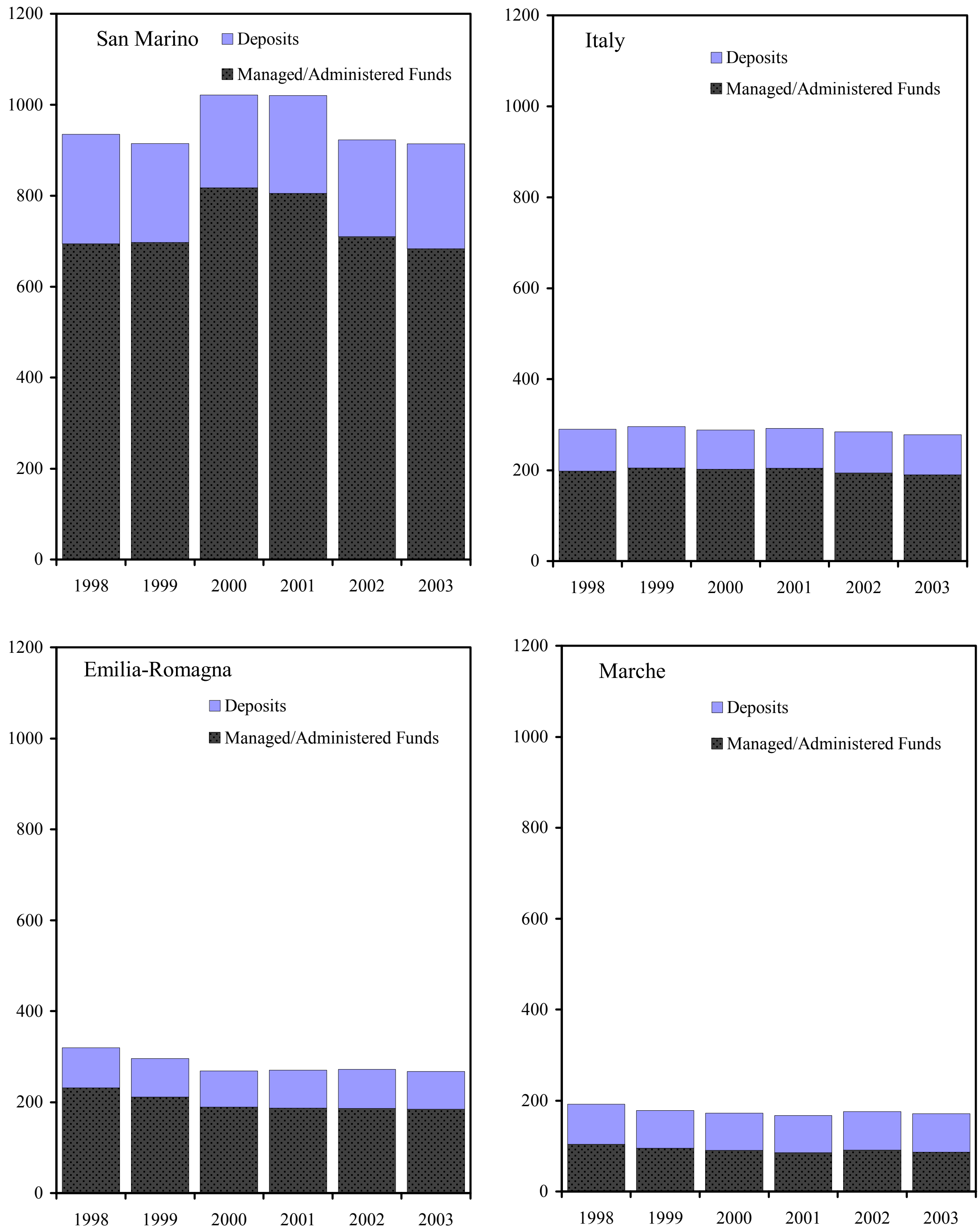


Breakdown of Private Sector Gross Profits by Economic Activity, 2002



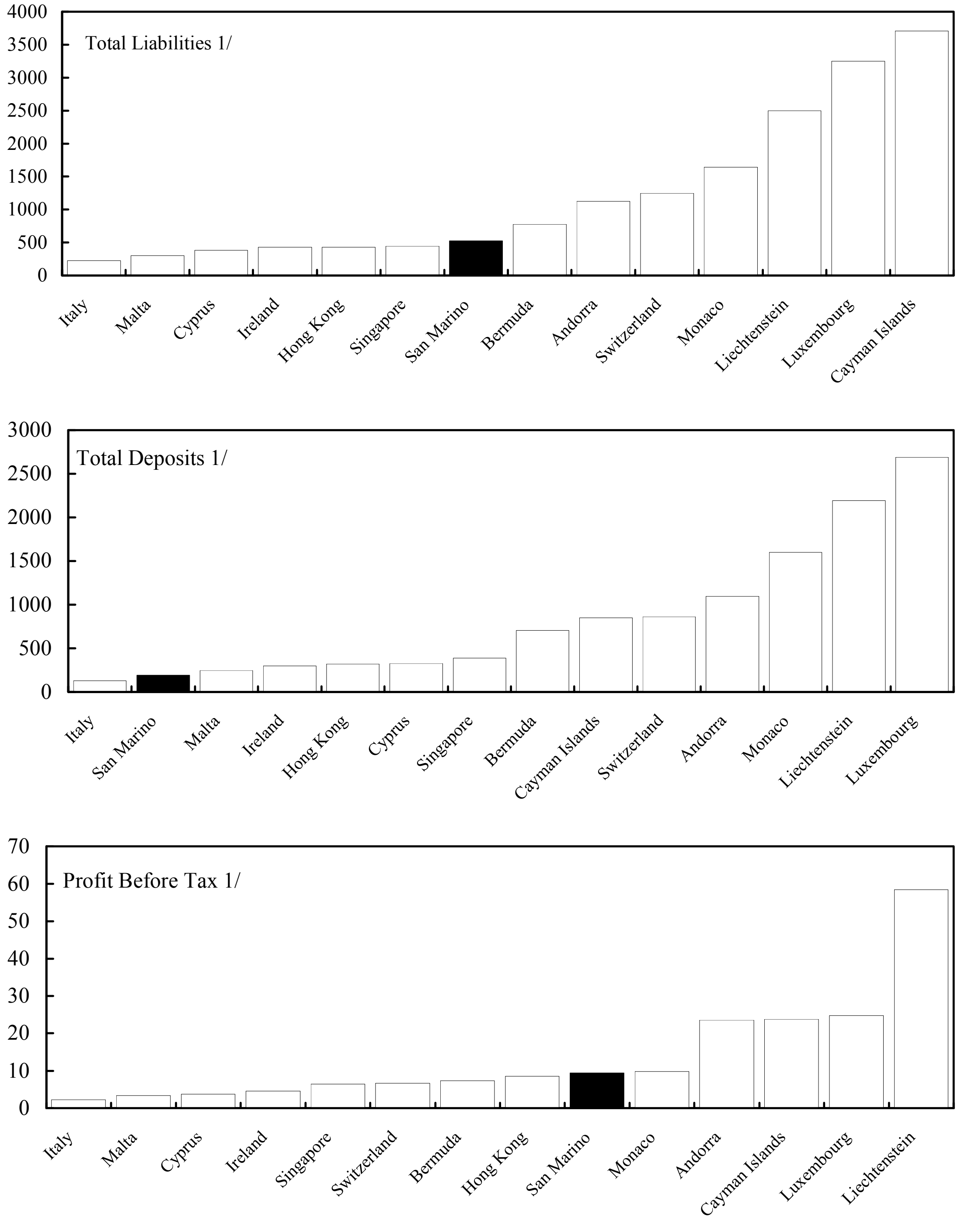
Sources: Sammarinese authorities; and Fund staff estimates.

Figure 4. San Marino: Bank Deposits and Managed/Administered Funds, 1998-2003
(In percent of GDP)



Sources: Bank of Italy; and Central Bank of San Marino, *Financial Statements 2003*.

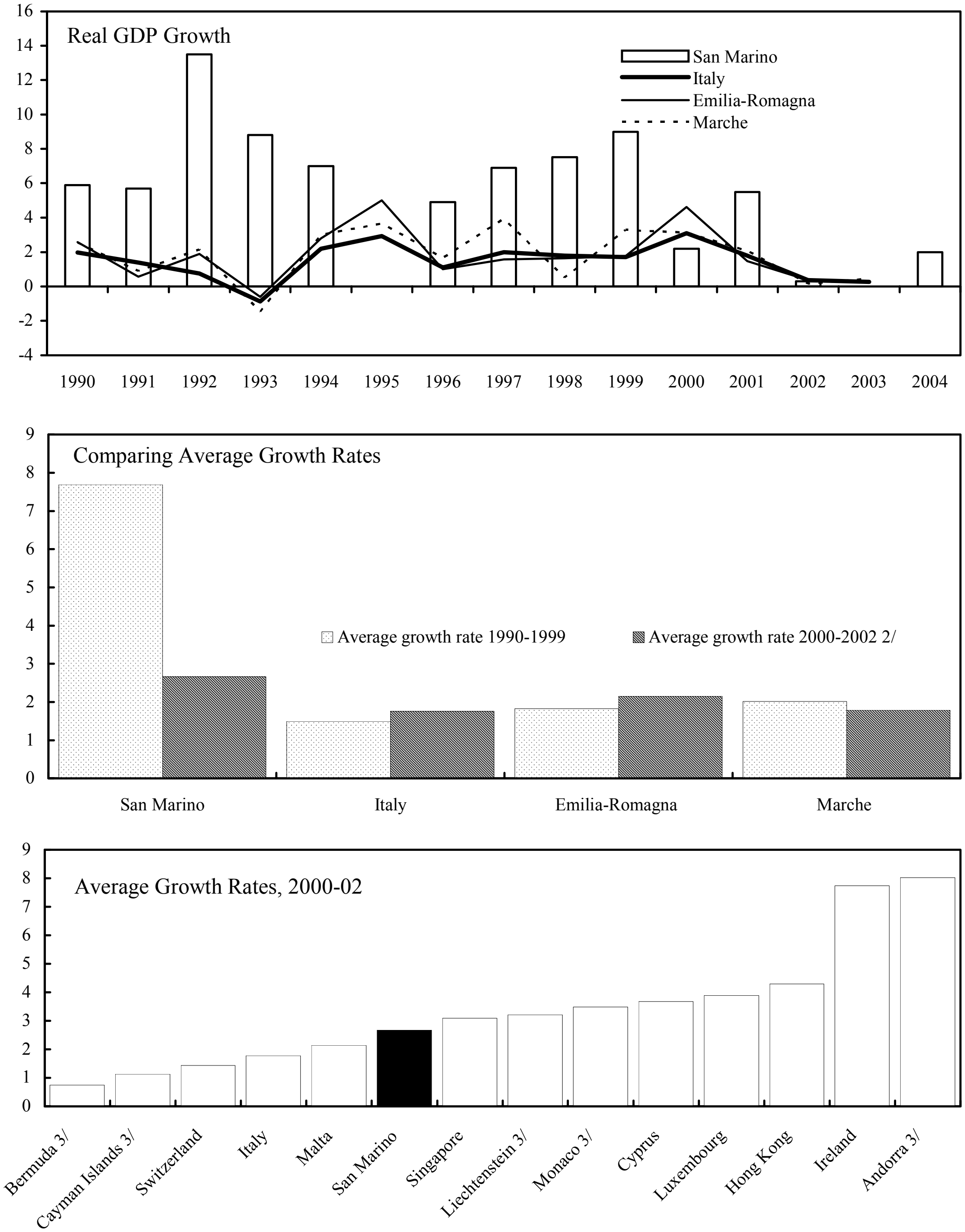
Figure 5. San Marino: Banking Sector Indicators, 1998-2002
(5-year average, in percent of GDP)



Sources: Bankscope; *World Economic Outlook;* United Nations; and Fund staff estimates.

1/ To ensure comparability, data for San Marino are also from Bankscope and differ from those in Figure 4. Specifically, total liabilities and deposits do not include managed/administered funds, although related commissions and fees contribute to profits.

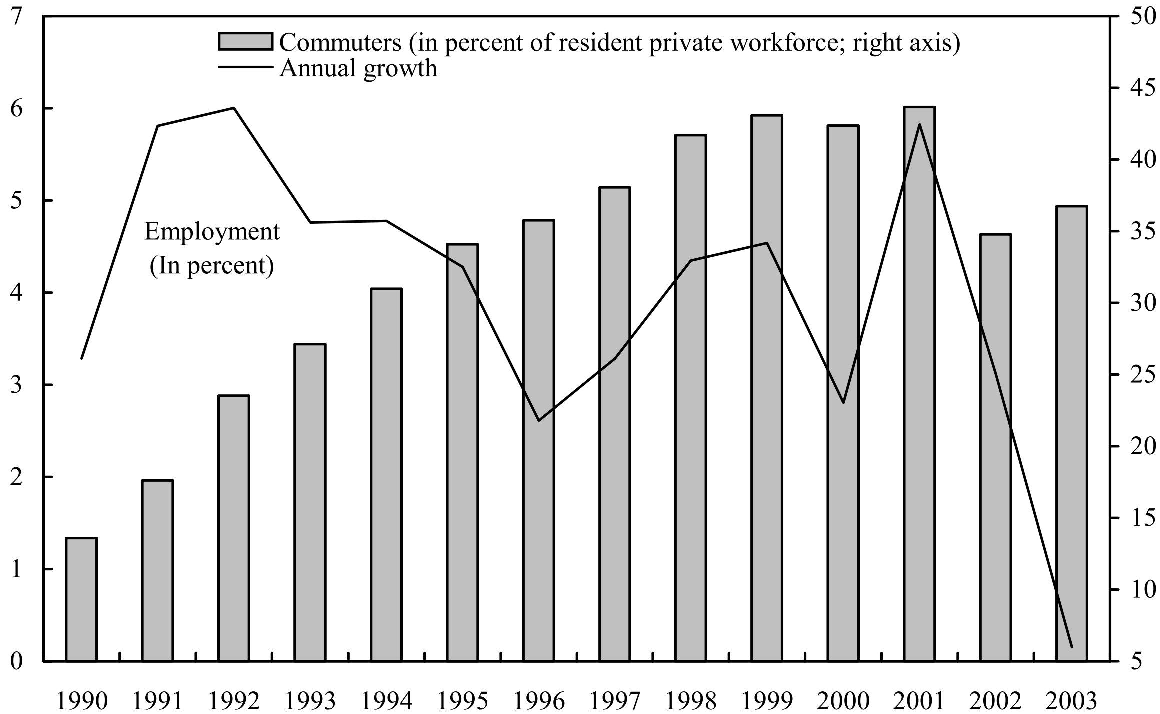
Figure 6. San Marino: Real GDP Growth, 1990-2004 1/
(In percent)

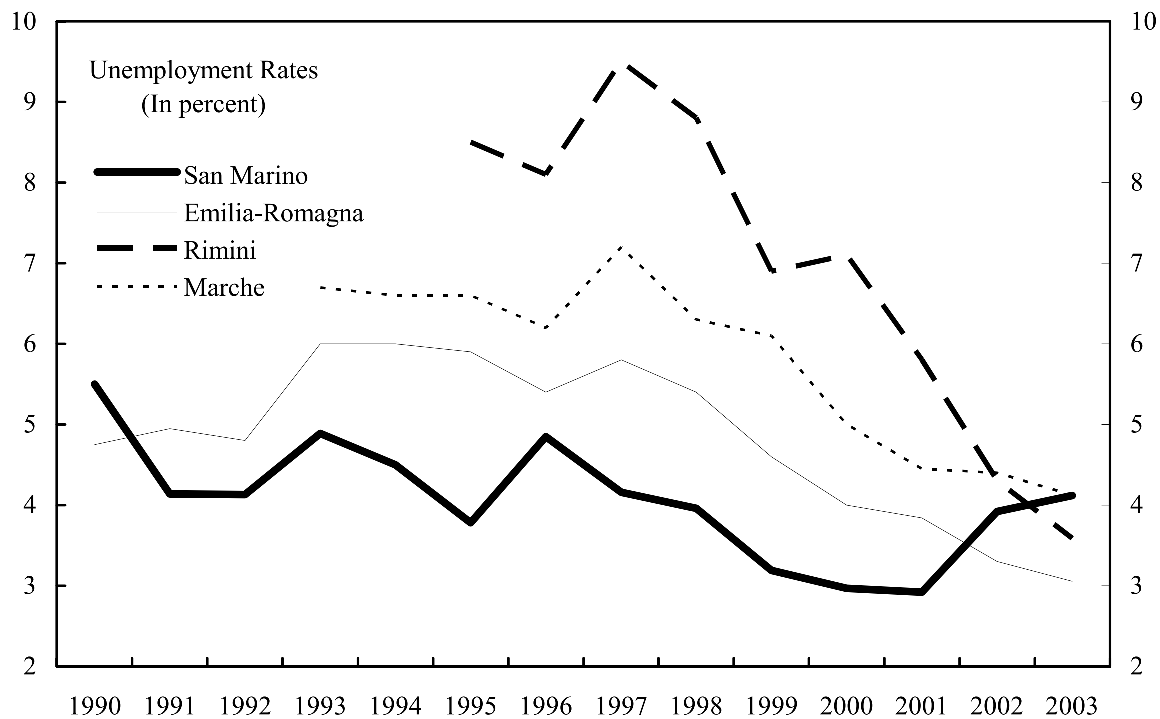


Sources: United Nations; Sammarinese authorities; SVIMEZ; ISTAT; and Fund staff estimates.

1/ For San Marino and the Italian regions data are ESA79 until 1995 and ESA95 thereafter. For San Marino, old and new data do not overlap.
2/ Data for 2003-04 are Fund staff estimates.
3/ Average for 2000-01.

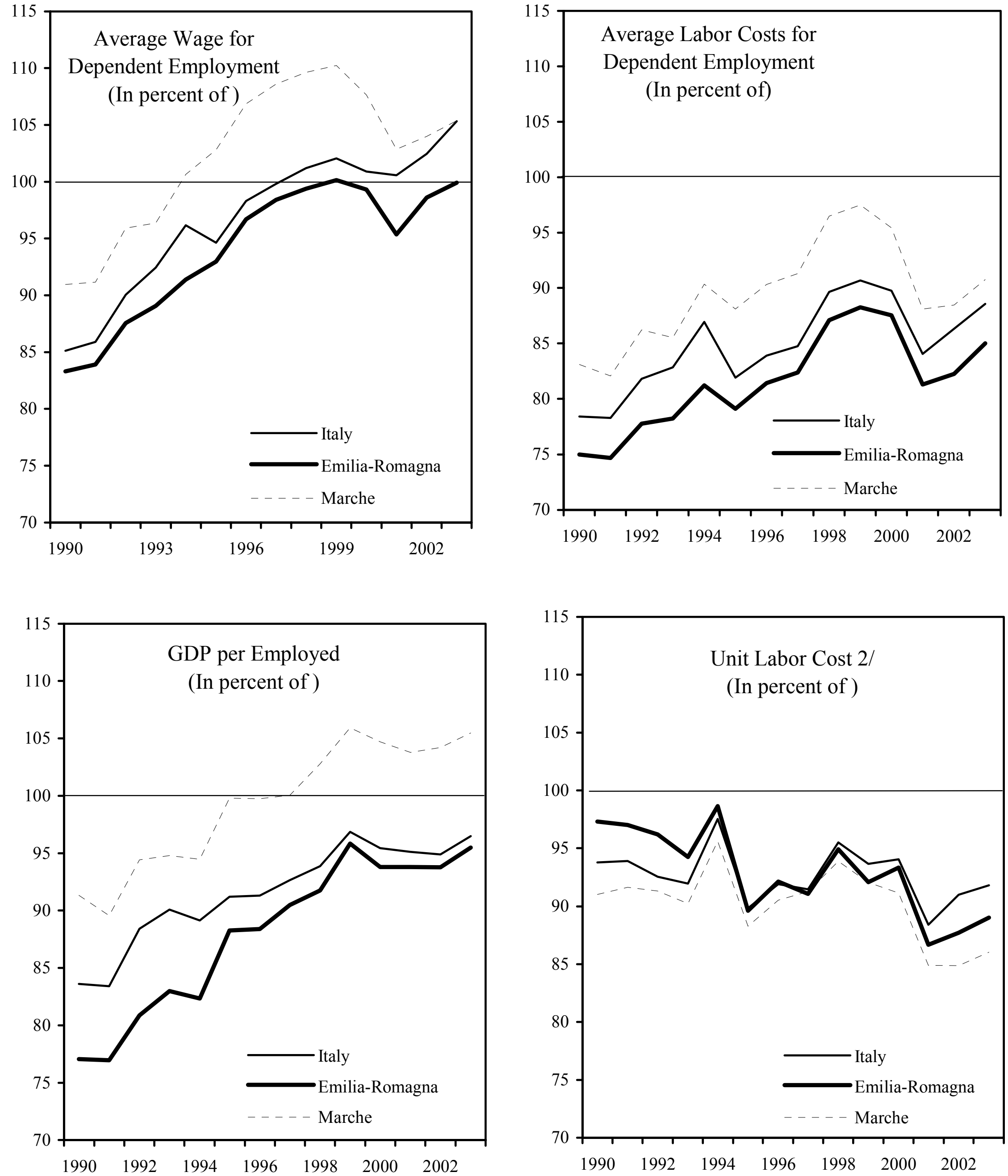
Figure 7. San Marino: Employment and Unemployment, 1990-2003





Sources: Sammarinese authorities; SVIMEZ; and ISTAT.

Figure 8. San Marino: Unit Labor Costs Compared, 1990-2003 1/
(In percent of Italy, Emilia-Romagna, or Marche)

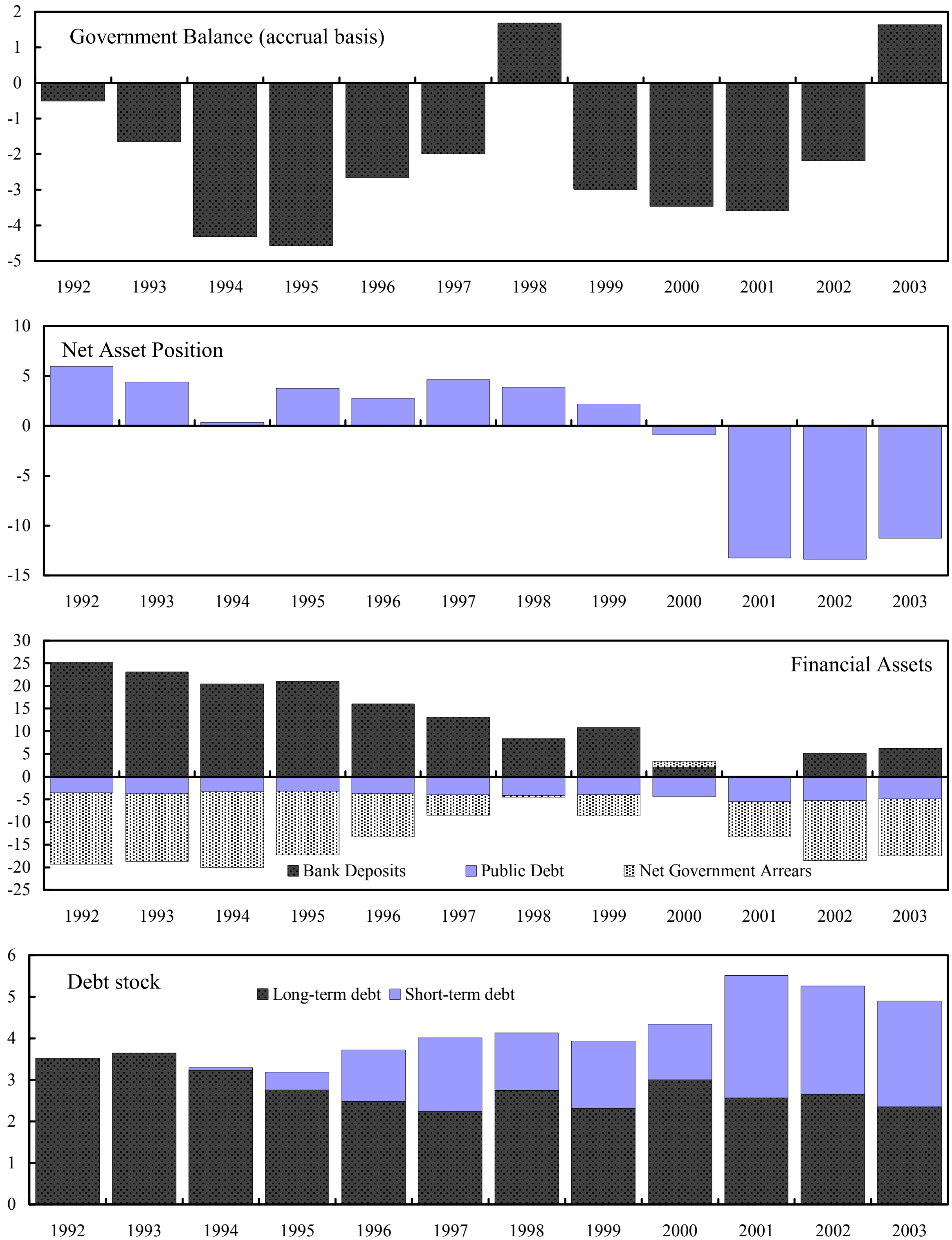


Sources: Sammarinese authorities; SVIMEZ; and ISTAT.

1/ Data before 1995 are on an ESA 79 basis; afterwards they are on an ESA 95 basis. For San Marino, data for 2003 are available only for wages and employment. Labor costs are assumed to have grown at the same rate as wages, as there were no changes in payroll taxes.

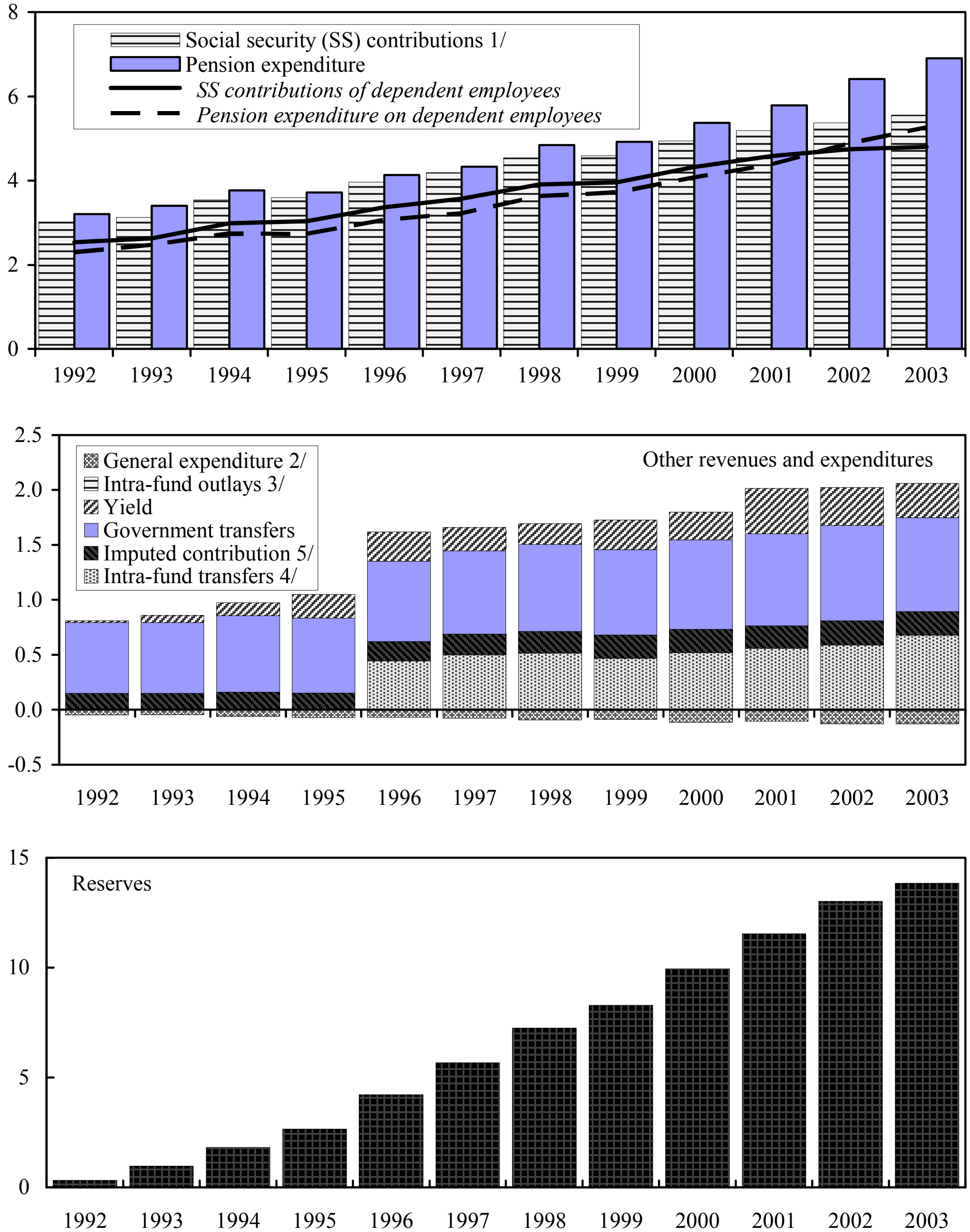
2/ Labor cost per employee divided by output per employed.

Figure 9. San Marino: Fiscal Developments, 1992-2003
(Central administration; in percent of GDP)



Sources: Sammarinese authorities; and Fund staff estimates.

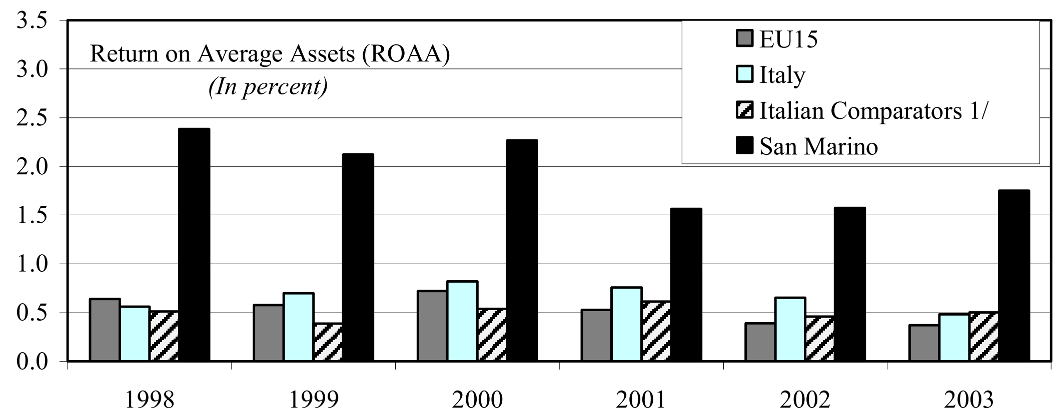
Figure 10. San Marino: Pension System, 1992-2003
(in percent of GDP)

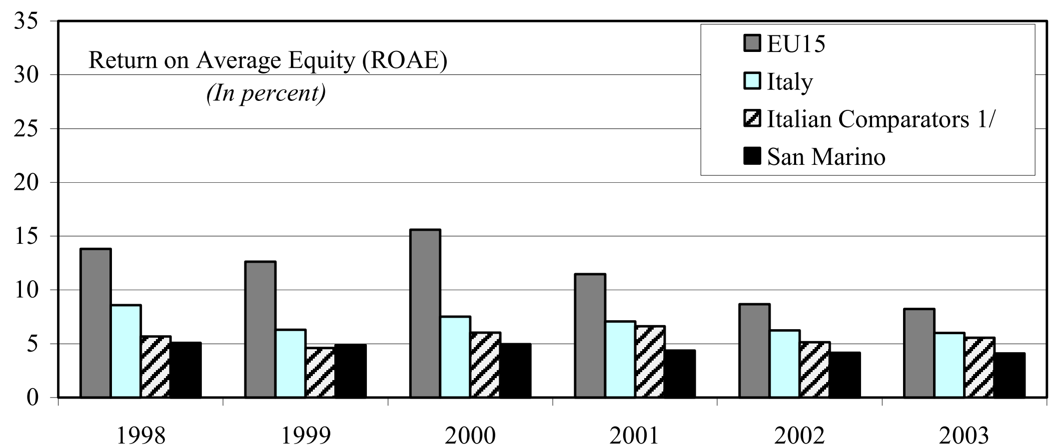


Source: Ufficio Programmazione Economica e Centro Elaborazione Dati e Statistica.
1/ Net of reimbursements.
2/ Portion of administrative expenditures borne by SSI.
3/ Amount of resources used to cover the deficit of voluntary pension funds.
4/ Surplus of the funds for family allowances and social service activities.
5/ SS contributions computed on the yearly allowances paid to dependent workers (i.e., sick leave, unemployment benefits, etc.)

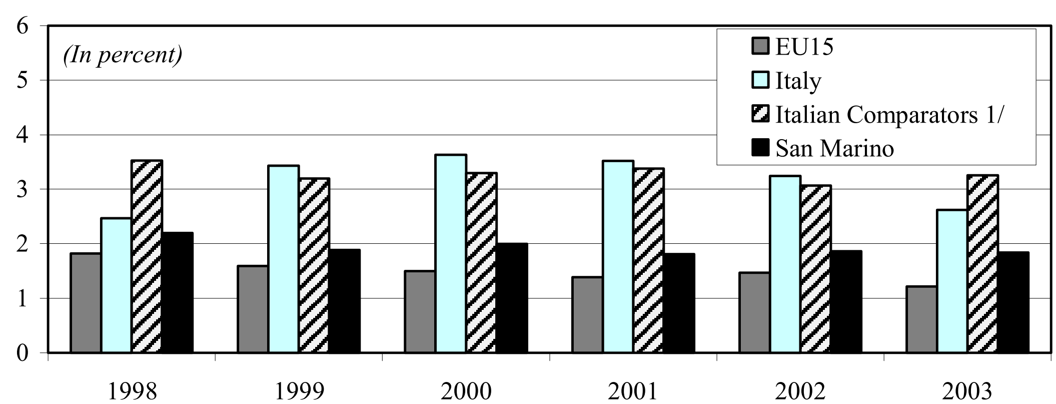
Figure 11. San Marino: Bank Profitability, 1998-2003

Profitability declined markedly ...





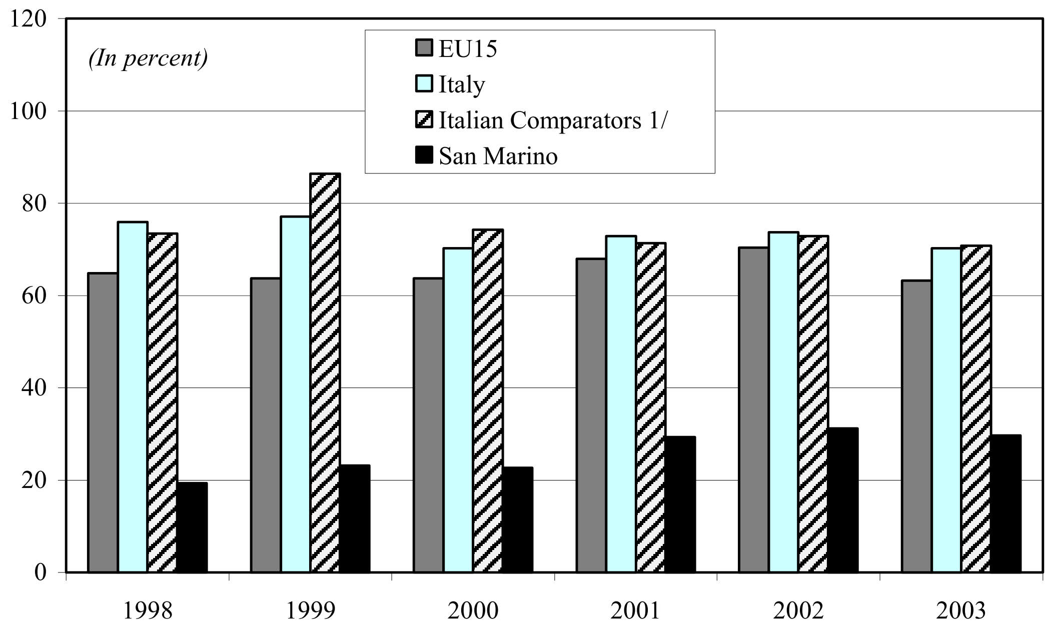
...even with relatively good net interest margin.



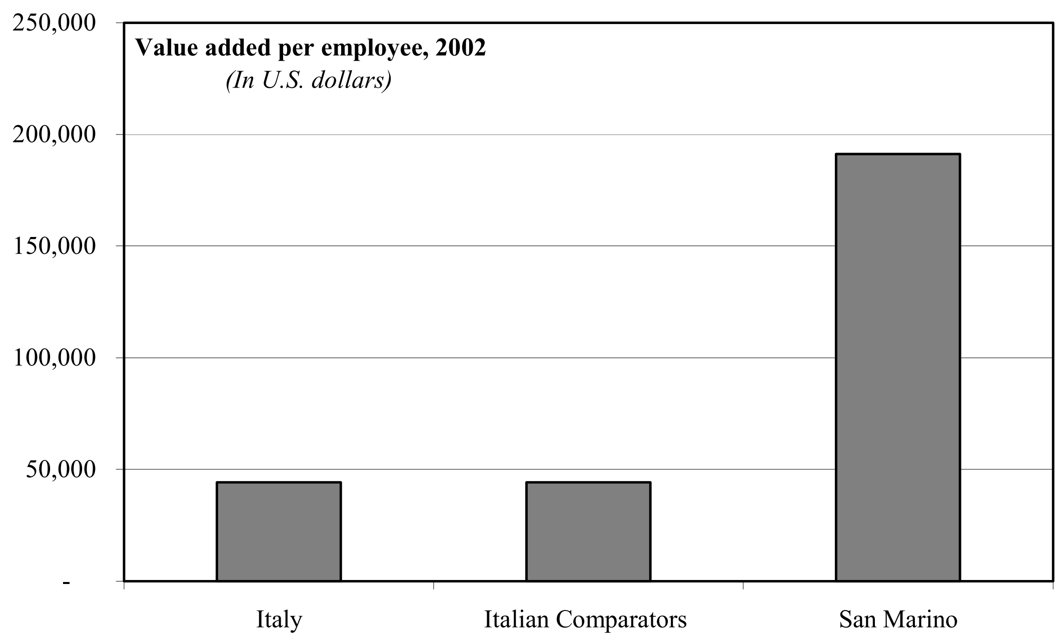
Sources: Department Supervision of the Central Bank of San Marino; and Bankscope.
1/ Banca delle Marche, Cassa di Risparmio di Rimini, Cassa di Risparmio di Cesena, Cassa di Risparmio di Ravenna and Banca Popolare dell'Adriatico.

Figure 12. San Marino: Bank Efficiency, 1998-2003

Cost income ratios are lower in San Marino ...



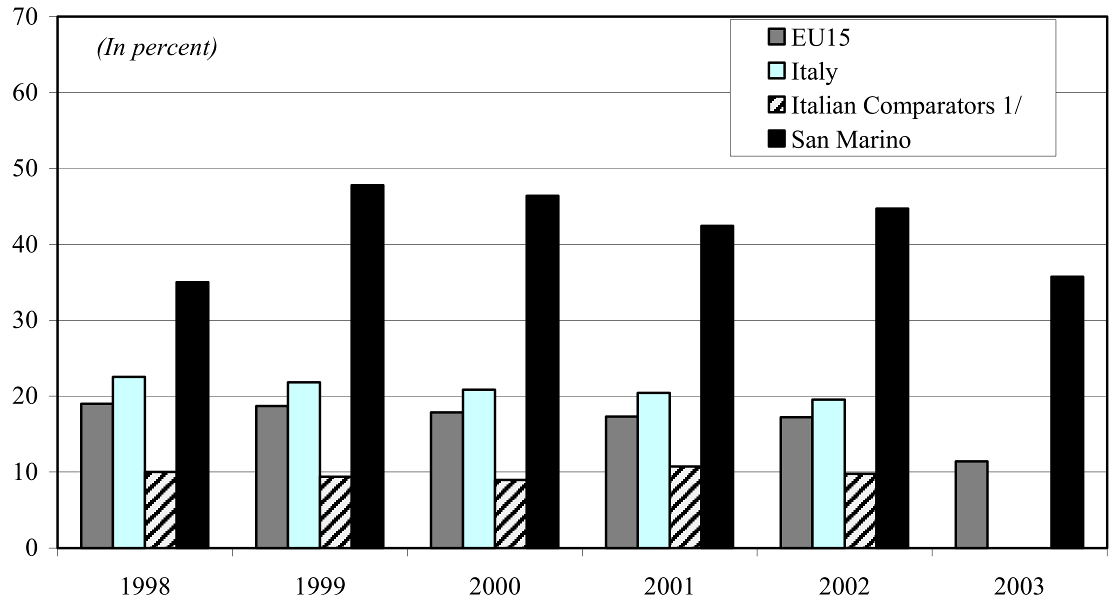
... and value added is higher than Italian banks.



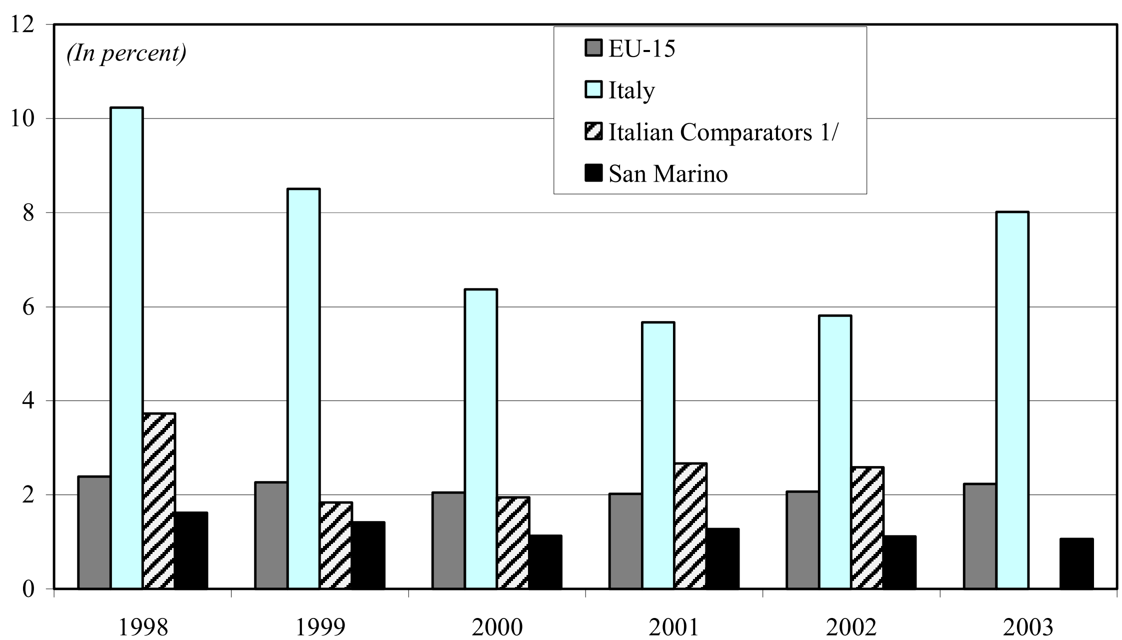
Sources: Department Supervision of the Central Bank of San Marino; and Bankscope.
1/ Banca delle Marche, Cassa di Risparmio di Rimini, Cassa di Risparmio di Cesena, Cassa di Risparmio di Ravenna and Banca Popolare dell'Adriatico.

Figure 13. San Marino: Capital Ratios and Non-Performing Loans, 1998-2003

Banks remain well capitalized with Tier 1 capital ratios well above Italian comparators.



Non performing loans remained low and well below Italian comparators.



Sources: Department Supervision of the Central Bank of San Marino; and Bankscope.
1/ Banca delle Marche, Cassa di Risparmio di Rimini, Cassa di Risparmio di Cesena, Cassa di Risparmio di Ravenna and Banca Popolare dell'Adriatico.

San Marino: Fund Relations
(As of April 30, 2004)

I. **Membership Status**: Joined 9/23/92. Article VIII.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	17.00	100.00
Fund holdings of currency	12.90	75.88
Reserve position in Fund	4.10	24.13

III. **SDR Department**:	SDR Million	Percent
Allocation		
Holdings	0.51	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate and Trade 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. A Monetary Agreement between the Italian Republic, on behalf of the European Community, and the Republic of San Marino, authorizes San Marino to use Euro notes and coins as the official currency. The central monetary institution is the Banca Centrale della Repub lica di San Marino. 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 may adopt the international security exchange restrictions applied by the EU by deciding to apply EC Regulations.[13] The basis of the EU's trade relationship with San Marino is the Agreement on Cooperation and Customs Union between the European Economic Community and the Republic of San Marino, which was signed in 1991 and entered into force on April 1, 2002, following ratification by all parties. Council Decision 2002/45/EC approves the Agreement and its accompanying Protocol.

VIII. **Article IV Consultation**: San Marino is on a 24-month consultation cycle; the last consultation discussions with San Marino were held in September 2001 and concluded on 12/5/2001 (EBM/01/124).

IX. **CTF**

X. **Technical Assistance**

Year	Dept.	Purpose	Date
1997	STA	Multisector assistance	3/97
2004	STA	Monetary and Financial Statistics	1/29–2/4, 2004

XI. **Resident Representative**: None.

[13] European regulations are not directly applicable to San Marino as a result of Article 249 of the Treaty Establishing the European Community, but they may well be applied at San Marino's initiative. Restrictions are in the process of being notified.

San Marino: Statistical Issues

Progress has been made, but there are important shortcomings in many areas of San Marino's statistical database due to difficulties in compiling basic data (stemming mainly from an absence of border controls) and a limited number of adequately trained personnel. The authorities recognize these deficiencies, and requested and received a STA multi-sector TA mission in 1997, and a STA Monetary and Financial Statistics TA mission in 2004. Authorities have recently requested TA in GFS compilation.

Since 1992 the authorities have produced an experimental set of **national accounts**. Data for 1995–99 have been calculated in accordance with ESA95. However, output data are published with two-year delay and sectoral value added is not available. As of 2004, consumer prices are collected directly at the source and published monthly with short delay. In addition, a first **survey on consumer and business confidence** is about to be completed.

The relevant cash and accrual data are collected but complete **government finance statistics** are unavailable and central government accounts are not presented according to standard IMF classifications. The central government **budget** is written so as to close at par, which implies that standard financing items, such as amortization, are included as an expenditure while ”borrowing requirement” is included among the revenues. In the event, however, revenue shortfalls have been financed by (i) drawing down deposits at the central bank; (ii) changes in volumes of payables/receivables; and (iii) new loans. The **deficit/surplus** concept monitored by the authorities (the *avanzo/disavanzo d'esercizio*) is the difference between the end of year result and the budget. This concept is different from a standard central government balance on an accrual basis, as it includes arrears and yet-to-be-collected revenues among accrued expenditures. The GFS database includes annual data for 1995 for the consolidated central government, compiled by the 1997 Multisector Statistics mission.

Regarding **monetary statistics**, the authorities have, since May 1997, provided balance sheet data on the commercial banks and the monetary authorities to the STA's EIS database. These data are provided on a quarterly basis, with approximately a six-week reporting lag. The authorities introduced laws and took some measures improving coverage and timeliness of banks' reporting, and the CBSM has improved sectorization (allowing for reliable identification of all transactions of the central government and the social security fund in monetary statistics) and expanded data collection to cover the offshore asset management activities of banks. A previous weakness of the data relating to the breakdown of deposits (and other assets and liabilities) between residents and nonresidents has been remedied. The authorities have changed banks' reporting requirements to obtain a breakdown of data on short-term credit by public and private sector components. However, there is no broad money survey, data on nonbank financial intermediaries are lacking, and CBSM's data on public sector deposits and banks' credits to the public sector do not match those of the Treasury.

San Marino does not compile **balance of payments accounts**. It has not committed the required resources, as the currency union with Italy (now superseded by the use of the euro) has made the balance of payments relatively unimportant as a policy consideration.

San Marino: Core Statistical Indicators as of June 17, 2004

	Exchange Rates	Interna-tional Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of Latest Observation	1/ 5/31/04	5/ March 2004	2/	March 2004	2/	March 2004	December 2003	4/ 2001	3/	2002	2002 3/
Date Received	6/5/04	May 31, 2004		May 31, 2004		May 31, 2004	April 2004	September 2003		September 2003	May 2004
Frequency of Data	Daily	Quarterly		Quarterly		Quarterly	Monthly	Annual		Annual	Annual
Frequency of Reporting	Daily	Quarterly		Quarterly		Quarterly	Quarterly	Annual		Annual	Annual
Source of Data	Reuters	CBSM		CBSM		CBSM	Statistical Office	Statistical Office		Budget Document	Statistical Office
Mode of Reporting	Electronic	Electronic		Electronic		Electronic	Publication	Publication		Publication	Publication 1/
Confidentiality	None	Internal		Internal		None	None	None		None	None

1/ San Marino officially adopted the euro as its currency since January 1, 1999, but the Italian lira remains the circulating currency. Exchange rate data for the euro are available on a continuous basis through Reuters/Bloomberg services.

2/ The Central Bank of San Marino (CBSM) does not engage in the full range of central bank functions because of the use of the euro as legal tender.

3/ San Marino does not produce official estimates of the balance of payments. National accounts data for 1994 and earlier are based on staff estimates and data provided by the authorities.

4/ National accounts data.

5/ San Marino reports data on monetary authorities' current accounts and time deposits at nonresident banks in euros and foreign currencies. However, these assets do not serve the same policy purposes of international reserves in other countries because San Marino does not have an independent monetary or exchange rate policy

Table 4. San Marino: Public Sector Debt Sustainability Framework, 1998-2008
(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1998	1999	2000	2001	2002			2003	2004	2005	2006	2007	2008	
								I. Baseline Projections						**Debt-stabilizing primary balance 11/**
Public sector debt 1/	4.1	3.9	4.3	5.5	5.3			**4.9**	**4.7**	**4.5**	**4.3**	**4.0**	**3.8**	**0.0**
o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Change in public sector debt	0.1	-0.2	0.4	1.2	-0.3			-0.4	-0.2	-0.2	-0.2	-0.2	-0.2	
Identified debt-creating flows (4+7+12)	-2.0	2.6	3.3	3.3	2.0			-1.8	0.4	-0.2	-0.2	-0.2	-0.2	
Primary deficit	-2.2	2.6	3.2	3.3	1.9			-1.9	0.3	-0.3	-0.3	-0.3	-0.2	
Revenue and grants	34.2	28.1	28.2	27.7	27.4			30.1	27.3	27.8	27.8	27.8	27.8	
Primary (noninterest) expenditure	32.1	30.7	31.3	31.1	29.4			28.2	27.5	27.5	27.6	27.6	27.6	
Automatic debt dynamics 2/	0.1	-0.1	0.1	-0.1	0.1			0.1	0.1	0.0	0.0	0.0	0.0	
Contribution from interest rate/growth differential 3/	0.1	-0.1	0.1	-0.1	0.1			0.1	0.1	0.0	0.0	0.0	0.0	
Of which contribution from real interest rate	0.4	0.3	0.2	0.2	0.1			0.1	0.2	0.2	0.2	0.2	0.2	
Of which contribution from real GDP growth	-0.3	-0.3	-0.1	-0.2	0.0			0.0	-0.1	-0.1	-0.1	-0.1	-0.1	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0			...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	2.2	-2.8	-2.9	-2.1	-2.3			1.4	-0.6	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	12.1	14.0	15.4	19.9	19.2			16.3	17.3	16.1	15.3	14.5	13.8	
Gross financing need 6/	0.0	4.4	4.9	5.0	5.3			1.2	3.3	2.6	2.4	2.3	2.2	
in millions of U.S. dollars	0.2	37.6	38.1	40.9	46.7	10-Year Historical Average	10-Year Standard Deviation	12.5	40.1	33.1	33.1	33.2	33.3	Projected Average
Key Macroeconomic and Fiscal Assumptions														
Real GDP growth (in percent)	7.5	9.0	2.2	5.5	0.3	5.2	3.3	0.0	2.0	3.1	3.1	3.1	3.1	2.4
Average nominal interest rate on public debt (in percent) 7/	12.8	9.3	7.9	6.7	4.7	10.6	4.2	4.6	6.2	6.2	6.2	6.2	6.2	5.9
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	11.0	7.7	5.3	3.9	2.3	6.6	5.9	2.1	4.1	4.2	4.2	4.2	4.2	3.8
Nominal appreciation (increase in US dollar value of local currency, in percent)	6.4	-14.2	-7.4	-5.3	19.0	-1.7	10.8	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	1.8	1.6	2.6	2.8	2.4	4.0	4.0	2.5	2.1	2.0	2.0	2.0	2.0	2.1
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	4.3	4.4	4.6	-5.2	0.8	3.0	-4.0	-0.4	3.2	3.2	3.1	3.1	1.4
Primary deficit	-2.2	2.6	3.2	3.3	1.9	2.2	1.8	-1.9	0.3	-0.3	-0.3	-0.3	-0.2	-0.4
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 10/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2004-08 8/								**4.9**	**6.6**	**8.9**	**11.2**	**13.6**	**15.9**	**0.2**
A2. Primary balance under no policy change in 2004-08								**4.9**	**2.6**	**0.8**	**-0.8**	**-2.4**	**-3.9**	**... 9/**
A3. Reduction in GDP growth (relative to baseline) of one standard deviation								**4.9**	**4.9**	**4.8**	**4.7**	**4.6**	**4.5**	**0.2**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2004 and 2005								**4.9**	**5.4**	**5.9**	**5.7**	**5.5**	**5.3**	**0.1**
B2. Real GDP growth is at historical average minus two standard deviations in 2004 and 2005								**4.9**	**5.8**	**8.1**	**10.2**	**12.3**	**14.5**	**0.1**
B3. Primary balance is at historical average minus two standard deviations in 2004 and 2005								**4.9**	**10.3**	**16.3**	**16.2**	**16.1**	**16.0**	**0.2**
B4. Combination of 2-4 using one standard deviation shocks								**4.9**	**8.9**	**13.8**	**13.7**	**13.6**	**13.5**	**0.1**
B5. One time 30 percent real depreciation in 2004 10/								**4.9**	**4.7**	**4.5**	**4.3**	**4.0**	**3.8**	**0.0**
B6. 10 percent of GDP increase in other debt-creating flows in 2004								**4.9**	**14.7**	**14.6**	**14.5**	**14.3**	**14.2**	**0.1**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ Derived as nominal interest expenditure divided by previous period debt stock.
8/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
9/ The calculation of the debt-stabilizing primary balance produces a non-sensical outcome when the imputed nominal interest rate (i.e. the nominal interest expenditure divided by previous period debt stock) turns negative.
10/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
11/ Assumes that key variables (real GDP growth, real interest rate, and primary balance) remain at the level in percent of GDP/growth rate of the last projection year.

Statement by the IMF Staff Representative
July 28, 2004

1. This statement reflects information that became available after the staff report was issued. It does not change the thrust of the staff appraisal.

2. The authorities have revised the 2003 fiscal data, raising the surplus of the central administration to 2.4 percent of GDP (up from a preliminary 1.6 percent of GDP). Lower transfers to the Social Security Institute (SSI)—mainly reflecting lower-than-projected personnel costs and purchases of goods and services of the public health system—fully account for the revision (see attached Table 2). This revision increases the likelihood that carry-over effects of the 2003 adjustment will allow an overperformance relative to the deficit target of about one half percent of GDP for 2004, as suggested in paragraph 14 of the staff report.

Table 2. San Marino: Central Administration Operations, Accrual Basis, 1992-2004

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004 Budget
						(Million of euros)							
Revenues 1/	143.9	157.2	172.4	174.8	191.2	206.4	247.7	224.7	236.6	252.6	256.4	288.5	271.9
Tax	101.5	116.5	129.2	128.3	139.5	157.1	177.8	170.9	182.5	196.7	198.2	219.7	208.8
Direct 1/	42.4	45.9	56.0	53.2	58.6	70.0	80.2	81.3	79.2	96.7	104.1	100.0	101.1
Import Tax 1/	49.3	61.0	61.4	62.8	68.9	74.4	84.9	74.5	87.3	82.3	71.8	94.9	86.3
Other indirect taxes	9.8	9.7	11.8	12.2	12.0	12.7	12.7	15.2	15.9	17.7	22.3	24.9	21.4
Non-Tax 1/ 2/	40.0	39.4	41.2	45.3	45.4	47.0	45.4	44.5	46.6	53.2	56.5	66.2	59.7
Asset Sales	2.3	1.2	2.0	1.2	6.3	2.3	24.5	9.3	7.5	2.7	1.7	2.6	3.5
Expenditure 1/	145.8	164.3	193.3	200.2	207.4	219.6	235.5	248.7	265.7	285.3	276.8	265.4	277.6
Current expenditure	118.5	141.5	153.3	159.6	171.6	186.3	198.8	221.9	235.6	240.2	251.9	243.6	254.2
Wages & Salaries	41.6	48.7	56.3	60.4	64.9	71.4	79.0	84.4	91.6	91.9	90.5	91.2	91.7
Transfers to Public Sector	54.7	53.3	57.9	72.2	75.0	61.3	81.8	98.1	99.4	109.9	123.0	116.2	115.7
o/w SSI	36.4	43.4	47.6	47.0	49.3	52.5	51.0	68.2	70.4	76.6	92.0	76.8	77.0
Transfers to Private Sector	...	...	...	6.7	6.8	7.9	8.8	8.4	8.9	6.3	9.7	8.0	7.6
Interest Payments	...	...	...	1.5	1.9	2.6	3.4	2.8	2.5	2.4	2.4	2.2	2.9
Others 3/	22.2	39.5	39.2	18.8	23.0	43.2	25.8	28.3	33.2	29.8	26.4	26.0	36.4
Capital expenditure	27.3	22.8	40.0	40.7	35.8	33.3	36.8	26.7	30.1	45.1	24.9	21.8	23.3
Transfers to Public Sector	12.1	10.3	10.3	10.4	13.7	14.8	12.7	11.2	15.0	12.7	3.1	7.9	6.1
Others	15.2	12.6	29.7	30.3	22.1	18.5	24.0	15.5	15.0	32.4	21.8	13.9	17.2
Balance	-2.0	-7.2	-20.8	-25.4	-16.2	-13.2	12.2	-23.9	-29.0	-32.7	-20.4	23.1	-5.6
Financing	2.0	7.2	20.8	25.4	16.2	13.2	-12.2	23.9	29.0	32.7	20.4	-23.1	5.6
Net Debt Financing	-0.2	2.3	0.1	1.8	4.8	4.0	3.4	1.6	4.9	13.8	-1.0	-2.2	5.6
Change in Deposits	-18.7	-3.5	1.7	-18.1	19.5	10.5	26.2	-26.1	68.5	17.9	-48.1	-18.8	0.0
Change in Net Government Arrears	20.9	8.3	19.0	41.7	-8.2	-1.2	-41.8	48.4	-44.3	1.0	69.6	-2.1	0.0
Memorandum Items:													
Tax reimbursements	59.4	66.2	82.5	108.4	158.4	188.4	183.9	236.3	180.6	224.4	216.4	226.5	251.1
Reassessment of old arrears	1.2	3.4	3.4	44.7	12.1	27.0	-14.9	13.6	3.7	-80.1	15.9	1.5	0.0
						(Percent of GDP)							
Revenues 1/	37.5	36.2	35.7	31.4	31.5	31.2	34.2	28.1	28.2	27.7	27.4	30.1	27.3
Tax	26.5	26.8	26.8	23.1	23.0	23.8	24.6	21.3	21.7	21.6	21.2	22.9	20.9
Direct 1/	11.1	10.6	11.6	9.6	9.7	10.6	11.1	10.2	9.4	10.6	11.1	10.4	10.1
Import Tax 1/	12.9	14.0	12.7	11.3	11.4	11.3	11.7	9.3	10.4	9.0	7.7	9.9	8.6
Other indirect taxes	2.6	2.2	2.4	2.2	2.0	1.9	1.8	1.9	1.9	1.9	2.4	2.6	2.1
Non-Tax 1/ 2/	10.4	9.1	8.5	8.1	7.5	7.1	6.3	5.6	5.6	5.8	6.0	6.9	6.0
Asset Sales	0.6	0.3	0.4	0.2	1.0	0.3	3.4	1.2	0.9	0.3	0.2	0.3	0.4
Expenditure 1/	38.0	37.8	40.0	36.0	34.2	33.2	32.6	31.0	31.6	31.3	29.6	27.7	27.8
Current expenditure	30.9	32.6	31.8	28.7	28.3	28.2	27.5	27.7	28.1	26.4	26.9	25.4	25.5
Wages & Salaries	10.9	11.2	11.7	10.9	10.7	10.8	10.9	10.5	10.9	10.1	9.7	9.5	9.2
Transfers to Public Sector	14.3	12.3	12.0	13.0	12.4	9.3	11.3	12.3	11.8	12.1	13.2	12.1	11.6
o/w SSI	9.5	10.0	9.8	8.5	8.1	7.9	7.1	8.5	8.4	8.4	9.8	8.0	7.7
Transfers to Private Sector	...	...	...	1.2	1.1	1.2	1.2	1.0	1.1	0.7	1.0	0.8	0.8
Interest Payments	...	...	...	0.3	0.3	0.4	0.5	0.3	0.3	0.3	0.3	0.2	0.3
Others 3/	5.8	9.1	8.1	3.4	3.8	6.5	3.6	3.5	4.0	3.3	2.8	2.7	3.7
Capital expenditure	7.1	5.3	8.3	7.3	5.9	5.0	5.1	3.3	3.6	4.9	2.7	2.3	2.3
Transfers to Public Sector	3.2	2.4	2.1	1.9	2.3	2.2	1.8	1.4	1.8	1.4	0.3	0.8	0.6
Others	4.0	2.9	6.1	5.4	3.6	2.8	3.3	1.9	1.8	3.6	2.3	1.5	1.7
Balance	-0.5	-1.7	-4.3	-4.6	-2.7	-2.0	1.7	-3.0	-3.5	-3.6	-2.2	2.4	-0.6
Financing	0.5	1.7	4.3	4.6	2.7	2.0	-1.7	3.0	3.5	3.6	2.2	-2.4	0.6
Net Debt Financing	-0.1	0.5	0.0	0.3	0.8	0.6	0.5	0.2	0.6	1.5	-0.1	-0.2	0.6
Change in Deposits	-4.9	-0.8	0.4	-3.3	3.2	1.6	3.6	-3.3	8.2	2.0	-5.1	-2.0	0.0
Change in Net Government Arrears	5.4	1.9	3.9	7.5	-1.3	-0.2	-5.8	6.0	-5.3	0.1	7.4	-0.2	0.0
Memorandum Items:													
Tax reimbursements	15.5	15.2	17.1	19.5	26.1	28.5	25.4	29.5	21.5	24.6	23.1	23.6	25.2
Reassessment of old arrears	0.3	0.8	0.7	8.0	2.0	4.1	-2.1	1.7	0.4	-8.8	1.7	0.2	0.0

Sources: Department of Budget and Planning, *Relazione Previsionale e Programmatica* ; and Fund staff estimates.

1/ Net of tax reimbursements.

2/ Includes custom duties, state monopolies, other special revenues, revenues from financial assets, interests on credits and deposits.

3/ Includes purchases of goods and services, remunerations for consultancies, contribution to interest payments on publicly subsidized loans, and transport costs.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

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Washington, D. C. 20431 USA

IMF Concludes 2004 Article IV Consultation with San Marino

On July 28, 2004, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with San Marino.[1]

Background

Growth of San Marino's economy has slowed considerably since 2000 with the fading of competitive advantages that had contributed to past rapid development. In the period 2000–2002, GDP growth decelerated to an average of about 2.8 percent, about one-third the pace achieved in the 1990s and below the growth rates of other small European countries over the last three years. Manufacturing and commerce faltered in the midst of inflexible labor markets, narrowing tax advantages, and greater price competition from nearby areas. In the financial sector, a flurry of new entrants, and the repatriation of Italian deposits in the wake of a tax amnesty, eroded profitability. Against this background, GDP is expected to rise by 2 percent in 2004, after stagnating in 2003.

After years of recurrent fiscal deficits, the government achieved a surplus of about 1.5 percent of GDP in 2003 owing to cutbacks in public sector employment, moderate growth in public sector wages, and better administration of indirect taxes. As a result, the net asset position of the central government—which had deteriorated by more than 15 percent of GDP in a decade—began to improve. For 2004, the carry-over effects of the 2003 adjustment and additional

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. 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. This PIN summarizes the views of the Executive Board as expressed during the July 28, 2004 Executive Board discussion based on the staff report.

measures in the budget should allow an overperformance relative to the deficit target of a half percent of GDP. Despite this positive short-term outlook, slow revenue growth and rising social security spending are a source of concern over the medium term. Total revenues of the central government fell by about 7.5 percent of GDP from 1992 to 2003, while pension expenditure grew by about 3.8 percent of GDP over the same period.

Recent initiatives improved the functioning of the labor and product markets, although some rigidities remain. The reduction in the public sector wage bill eliminated a long-standing source of wage-drift and loss of competitiveness, while new regulations accelerated the procedures to authorize nonresidents' hiring.

In the financial sector, Sammarinese banks remain somewhat more efficient and better capitalized, and have fewer nonperforming loans, than comparators. A heightened competitive environment enhanced the quality of services offered, but also put pressure on profits. In view of these trends, the authorities' have started to revamp the financial sector's legislative and regulatory framework by adopting Basel I and merging the *Istituto di Credito Sammarinese* (ICS)—the former central bank—and the Office of Bank Supervision. Parliament recently approved new provisions for anti-money laundering and combating the financing of terrorism (AML/CFT) to bring San Marino further in line with international standards.

Executive Board Assessment

They welcomed the indications that an economic recovery appears to be underway, and commended the government for its intention to pursue an ambitious reform agenda aimed at returning San Marino to a high growth path. They observed that important synergies could arise from maintaining a budget surplus, introducing a comprehensive reform of the pension system, eliminating residual labor and product market rigidities, and upgrading the regulatory and legislative framework of the financial sector.

Directors noted that, in the short run, the improved global outlook would benefit both San Marino and its main trading partners, creating conditions favorable to pressing ahead with reform plans. Foreign demand could be expected to drive a recovery in manufacturing and tourism, while an upward shift in interest rates should raise the profitability of the banking system. Directors nevertheless pointed to the taxation of Italian commuters—as a result of the introduction of a bilateral treaty between San Marino and Italy—and prospective EU-related changes in savings taxation as possible downside risks for employment and growth.

Directors commended the decisive fiscal correction of 2003 and encouraged the authorities to continue improving the net financial position of the central administration, within their overall objective of achieving budgets in balance or surplus over the medium term. This would ultimately restore the government's ability to buffer adverse external shocks. Achieving this goal would require further reductions in the public sector wage bill, supplemented by significant improvements in tax administration and a scaling back of generous entitlement programs. Directors welcomed the decision to eliminate substantial tax exemptions, but highlighted the importance of giving the tax collection agency access to financial information on non-complying taxpayers. Directors also praised the ongoing initiatives to improve public expenditure management. They welcomed also the recent administrative measures aimed at reducing costs in the public health system, and suggested that the government should stand ready to introduce monetary disincentives should these measures fail to curb the growing demand for health services.

Directors welcomed the authorities' intention to press ahead with a reform of the pension system. They observed that even if past high employment growth continued, generous benefits and population aging would lead to widening deficits and substantial increases in the public debt. Directors endorsed a comprehensive and far-reaching reform that would link pensions to social security contributions over the entire working life, thus reducing incentives to underreport incomes and improving the financial situation of those pension funds that had been in deficit for years. Some Directors saw scope for an even more ambitious reform, taking advantage of the substantial reserves for introducing a fully-funded system.

Directors called for a deepening of labor and product market reforms. A number of Directors noted that matching the enhanced labor market flexibility of neighboring Italian regions was key to continue attracting foreign investment. In this connection, they encouraged the authorities to introduce fixed-term contracts for Sammarinese workers and liberalize further rules governing the hiring of nonresidents. More generally, Directors urged the authorities to pursue with determination their stated goal of substituting rules for political discretion in key areas of economic activity.

Directors supported the authorities' efforts to upgrade the financial sector's legislative and regulatory framework with the aim of enhancing its competitiveness while safeguarding its soundness. They called for a quick approval of the law creating the new Central Bank of San Marino (CBSM), whose governance structure should ensure a stable source of financing, clear lines of accountability to Parliament, and operational independence from the government and the banking sector. Several Directors encouraged the government to take this opportunity to transfer the authority to license financial institutions to the CBSM.

Directors emphasized the importance of enhancing supervisory practices, with more frequent on-site inspections and vigorous enforcement of international standards. They welcomed the ongoing expansion of supervisory staff, which could help ensure that declining profitability did not lead to increased risk-taking by banks. Some Directors observed that the EU-related increase in withholding taxes would reduce the appeal of traditional banking and stressed that the CBSM needed to gear up for the broader range of services and products that would be offered. Directors welcomed San Marino's intention to request a Financial Sector Assessment Program (FSAP) and commended its commitment to counter money laundering and the financing of terrorism.

Directors welcomed the progress made in improving San Marino's statistical database, but expressed concern that important shortcomings remained. They encouraged the authorities to devote additional efforts to the compilation of timely national account statistics and general government accounts in line with Eurostat's ESA95 methodology.

Directors urged San Marino to move toward providing official development assistance in line with the UN-recommended target.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

San Marino: Selected Economic Indicators

	1999	2000	2001	2002	2003	2004 1/
Real economy (change in percent)						
Real GDP 2/	9.0	2.2	5.5	0.3	0.0	2.0
Employment	4.5	2.8	5.8	3.1	0.8	1.8
Unemployment rate (in percent)	3.2	3.0	2.4	3.9	4.5	2.9
Consumer prices (percent change, period average)	1.6	2.6	2.8	2.3	2.5	2.1
Wages	3.9	1.9	-0.5	3.7	5.7	...
Public finance (in percent of GDP) 3/						
Central government balance	-3.0	-3.2	-3.6	-2.2	2.4	-0.6
Central government deposits	10.8	2.2	0.0	5.2	7.0	6.7
Gross public debt	3.9	4.3	5.5	5.3	4.9	5.3
Interest rates (end of period)						
Loans	7.9	9.2	8.8	8.0	7.1	...
Time deposits	2.5	2.6	2.9	2.7	1.6	...
Balance of payments 4/						
Trade balance (in millions of US$)	-21.1	-44.6	-38.0	-100.9	...	...
Exports (in percent of GDP)	197.4	193.8	186.8	177.6	...	...
Imports (in percent of GDP)	200.0	199.5	191.5	187.9	...	...
Fund position (as of May 31, 2004)						
Holding of currency (in percent of quota)					75.88	
Holding of SDRs (in percent of allocation)					n.a.	
Quota (in millions of SDR)					17.00	
Exchange Rate						
Exchange rate regime			Uses euro			
Present exchange rate (July 22, 2004)			US$ 1.2268 per euro			
Nominal effective (lira, 1990=100) 5/	74.1	70.7	71.2	72.1	75.3	76.6
Real effective (lira, 1990=100) 5/	84.1	80.7	81.7	83.5	88.1	89.8

Sources: Sammarinese authorities; Fund staff estimates and projections; and International Financial Statistics database.

1/ Fund staff estimates, unless otherwise noted.
2/ Data for 2003 are Fund staff estimates.
3/ Data are on an accruals basis. Budget figures for 2004 and final outturn for 2003.
4/ Based on national account data.
5/ Annual average. Data for 2004 are average through end-March.

Statement by Pier Carlo Padoan, Executive Director for San Marino
July 28, 2004

At the outset, I want to convey my authorities' deepest appreciation for the work done by the mission headed by Mr. Prati. As with previous missions, my Sammarinese authorities have greatly benefited from Staff advice and continue to enjoy a fruitful relationship with the Fund.

Recent Developments

Recent data suggest that the economic recovery is under way, reflecting an improved international economic environment. In May, unemployment decreased to 3.17 percent against 4.09 in the same period of 2003 while imports have picked up increasing to 6 percent in the first quarter of the year against the same period in 2003.

Recently, the authorities have started a thorough discussion in the country and with their international partners on how best to promote economic growth in San Marino in light of ever-increasing international cooperation that could benefit their small and open economy by strengthening its competitiveness vis-à-vis its current and potential trading partners.

Along these lines, the administration has been very active in the area of international cooperation, and has pursued a number of agreements in the area of economic cooperation with Austria, Croatia, Italy and Ukraine. Other agreements with the aim to avoid double taxation are currently being pursued with Belgium, Austria, Croatia and Malta, while negotiations are about to start with Cyprus, Luxembourg and Slovenia.

With reference to the taxation of savings of non residents, an agreement – whose main aspects are described in the Staff report – has been reached, in principle, with ECOFIN, which will be finalized in the months ahead with the EU Commission and the member States.

Fiscal Policies

Following a decade of budget deficits resulting in a deterioration of the underlying fiscal position, the authorities have enacted a fiscal adjustment plan bringing the central government balance into surplus to 2.4 percent of GDP in 2003 against a deficit of 2.2 percent the year before. This outcome is part of a wider strategy aimed at ensuring a fundamentally sound fiscal position of the central government as the fiscal adjustment will continue in the years ahead with essentially balanced-budget targets.

In this setting, the authorities have been considering a series of measures aimed at strengthening tax administration and collection while improving the management of public expenditures. In this respect, they are establishing an accounting inspectorate body for strengthening the management of the public administration.

The Financial Sector and Anti-Money Laundering Surveillance

The authorities envisage a greater role for the financial sector in contributing to the Sammarinese economic growth. As noted by Staff, its currently limited dimensions are indicative of a potentially likely expansion in the future that the authorities encourage in full compliance within the current international regulatory framework.

The authorities envisage the development of the Sammarinese financial sector on three pillars. First, they have proceeded to strengthen the institutional framework, by merging the supervisory agency with the Central Bank, as outlined in the Staff report. The hiring of new human resources is expected to further strengthen the role of the Central Bank vis-à-vis the supervision of banking and financial markets.

The second pillar is centered on the adequacy of the supervisory framework. The Central Bank introduced early this year a new supervisory framework on capital adequacy based on Basle I to be complemented later this year by a regulation on market and derivates risks. The latter is being currently developed by the Central Bank's supervisory wing and it is expected to be completed by the end of the summer.

The third pillar refers to opening the system to a greater international scrutiny in order to benefit from the introduction of international best practices. In this setting, the authorities see as potentially helpful an FSAP mission, as noted in the Staff report. This issue has been preliminary discussed within the Finance Ministry and the Central Bank and it has been brought on the agenda of the forthcoming general meeting of the Government (*Congresso di Stato*) on August 2, at which time the authorities will be able to provide a formal response to the Staff invitation to undertake an FSAP.

Importantly, the development of the Sammarinese financial sector has occurred in the context of a strengthened Anti-Money laundering surveillance. The authorities have subscribed to all the relevant international agreements like the 1990 Strasbourg Convention and are a member of the Council of Europe Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures. They are constantly engaged with other international partners to support initiatives aimed at anti-money laundering and have opened themselves up to greater scrutiny. Just recently, a report from a Moneyval mission hosted by San Marino in 2003 has been finalized and will be discussed in January 2005.

The authorities are currently extending the notification requirements for anti-money laundering purposes to a number of parties other than banks and financial firms in accordance with the EU regulation (Directive 97/2001). Furthermore, the Central Bank – with the assistance of Italy's anti-money laundering agency Ufficio Italiano Cambi – has applied for membership to the Egmont Group. It is expected that such a membership will become operational by mid-2005.