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Republic of San Marino: 2009 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice; and Statement by the Executive Director for the Republic of San Marino

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2009 Article IV consultation with San Marino, the following documents have been released and are included in this package:

- The staff report for the 2009 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **November 23, 2009**, 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 **February 2, 2010**. 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 supplement of **February 16, 2010**, updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 17, 2010 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for San Marino.

The document listed below will be separately released.

Selected Issues Paper

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

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REPUBLIC OF SAN MARINO

Staff Report for the 2009 Article IV Consultation

Prepared by Staff Representatives for the 2009 Consultation with the Republic of San Marino

Approved by Adam Bennett and Thomas Dorsey

February 2, 2010

EXECUTIVE SUMMARY

Background. As well as suffering from the global crisis, the economy of San Marino is also facing financial stress related to (i) exposure of the largest bank to a troubled Italian banking group, and (ii) sizable deposit outflows following an Italian tax amnesty.

Challenges. San Marino's most immediate challenge is to complete the orderly unwinding of the banks' positions in connection with the recent liquidity stress, at a time when there is also a need to strengthen the capital base of its largest bank. In addition, the authorities have to adopt appropriate fiscal policies to support the economy in the current downturn. Medium-term challenges are four-fold: plan ahead for fiscal consolidation, strengthen the enforcement capacity of financial sector supervision and anti-money laundering and combating the financing of terrorism (AML/CFT), enhance the lender-of-last resort (LOLR) capacity of the Central bank of San Marino (CBSM), and establish a business environment supportive of a repositioning of the economy to an international environment characterized by greater financial transparency.

Staff views. Short-term fiscal policy measures are broadly appropriate. Measures to address liquidity pressures in the financial sector have helped the orderly unwinding of banks' positions, and plans to increase the capital of the largest bank, when implemented, should enhance its financial strength, but significant vulnerabilities remain. Initiatives already taken by the authorities to enhance international cooperation and transparency will serve as a foundation upon which the economy can reposition itself; the authorities should also explore ways to enhance cooperation with the euro area and seek access to Eurosystem liquidity for the banks. Medium-term fiscal sustainability would benefit from reduced current spending, pension reforms, and co-payments on selected health care services. Product and labor market flexibility needs to be enhanced.

Authorities' views. The overarching objective of the authorities is to strengthen San Marino's international integration, and to facilitate the transformation of the country's business model through appropriate macroeconomic and structural policies. The authorities were generally in agreement with Fund recommendations, while expressing a need for caution with regard to the liberalization of some sectors (i.e., real estate and telecommunication) and the labor market.

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I. THE CONTEXT AND OUTLOOK

A. Key Features of San Marino's Economy

1. **San Marino is a tiny landlocked republic with close links with Italy. Both** countries are bound by a customs union; about 90 percent of trade is with Italy, and 30 percent of the labor force is comprised of Italian commuters. Ties with Italy have been strengthened by the signature of Economic and Financial Cooperation agreements in March and November 2009 respectively, and a Double Taxation agreement is expected in 2010.

2. **Although the euro is its official currency, San Marino does not formally belong to the euro area, and the CBSM has a limited lender-of-last resort (LOLR) capacity**. San Marino uses the euro on the basis of a formal arrangement concluded in 2000 with the European Community, through a monetary agreement with Italy—on behalf of the European Community. The CBSM is not a member of the European System of Central Banks (ESCB) and has limited ability to respond to a systemic liquidity shock (see Selected Issues Paper). Local banks do not have access to Eurosystem liquidity and have only indirect access to the EU area payment systems via Italian banks acting as direct participants on behalf of San Marino banks. Such an arrangement generates credit risk, potential additional costs, and uncertainty to execute cross-border transactions if a direct participant cannot be found.

3. **San Marino's banking sector has contributed to high growth, but such a performance has come at the price of elevated macro-financial vulnerabilities**. The capitalization of the banking sector is high by international standards (Figure 3). But the ratio of total assets of the financial sector to GDP has grown steadily over the past few years, from 700 percent in 2003 to close to close to 900 percent at the end of 2008 (Figure 3). Macro financial vulnerabilities are high—especially in view of the limited LOLR capacity—and they are exacerbated by the concentration of the banking sector, with the first three largest and systemically important banks accounting for about 75 percent of total assets.

B. Several Coincident Challenges are Weighting on the Outlook

4. **The global financial crisis began to affect the economy of San Marino in the second half of 2008 and is likely to continue to do so in 2009–10, with risks tilted to the downside due to uncertainties in the banking sector outlook**. Growth turned negative by 1.1 percent in 2008 and the downturn has worsened in 2009, with projected growth down to minus 5 percent. Growth is likely to remain negative, at minus 1.8 percent, also in 2010 partly due to the impact of the Italian tax amnesty on financial services. As a consequence, unemployment is on the rise and inflation is declining. The unemployment rate is expected to reach 5.1 percent in 2009 and 5.5 percent in 2010, from 3.1 in 2008, while inflation will decelerate from 4.3 percent in 2008 to 2.4 percent in 2009 and slightly rebound to 2.7 percent in 2010. Due to the sharp deterioration in domestic demand, the trade balance is expected to improve to 17 and 20 percent of GDP in 2009 and 2010, respectively.

5. **Two concurrent events are creating significant vulnerabilities in the financial sector**. First, the largest bank (*Cassa di Risparmio della Repubblica di San Marino*-CRSM) has a large exposure to its Italian subsidiary (Delta) which is now facing financial difficulties. In May 2009 Italian police placed under custody the senior management of CRSM and Delta on account of money-laundering allegations. Shortly afterwards, the Bank of Italy put Delta under special administration and stripped CRSM's authorization to own stakes in Delta. Second, effective September 2009, the Italian government adopted a tax amnesty allowing individuals and business to avoid sanctions provided they disclose and repatriate their off-shore assets. The measure created a risk for large deposit outflows.[1]

6. **The recently conducted Financial Sector Assessment Program indicates that while the system so far has withstood pressures relatively well, vulnerabilities remain (Box 1).** Most notably, a further deterioration in the financial position of the Delta Group beyond what has already been recognized would weaken CRSM capitalization, with potentially systemic implications. With regard to liquidity, as of December 15, about 29 percent of total deposits and related investments had benefited from the tax amnesty, with an impact on banks' liquidity of 2.3 billion euros. An additional 220 million will be repatriated to Italy before June 15, 2010 (see paragraph 14). So far, all the banks have been able to meet depositor requests, but the extension of the tax amnesty until end-April 2010 could lead to new pressures.

7. **San Marino needs also to review its "business model".** Its economy must adjust to the new international environment of greater transparency in economic and financial areas. But it is not yet clear how the financial sector and, more broadly, the economy will adapt to the end of activities based on limited bank secrecy. While this new environment presents additional challenges for policymaking, the authorities sees these developments as sources of new opportunities for the economy which they intent to seize.

[1] Initially planned to end on December 15, 2009, the tax amnesty was extended until the end of April 2010, and the penalty increased from 5 to 6 percent until February 2010, and then to 7 percent.

Box 1. Key Conclusions of the FSAP

Short-term vulnerabilities

- Official data originally indicated that as of June 2009 the average risk-weighted capital adequacy ratio (CAR) of the system was 15.4 percent, but subsequent revaluation of non traded equity holdings of banks as of that date brought the figure down to 11.0 percent. Two banks with over a third of banking sector assets have CARs below 7 percent, and one has a CAR below the 11 percent minimum required by 2013.

- Stress tests indicate that the main vulnerabilities of the banking sector relate to deposit outflows or to a deterioration of credit quality and these risks are particularly high for the largest bank. Most banks are liquid and well-capitalized, and would be resilient to outflows as long as they can easily liquidate their securities portfolios or borrow from other more liquid banks, but the largest bank is vulnerable.

- The banks' vulnerability to a decline in credit quality is amplified by highly concentrated loan portfolios, which had been facilitated by lax prudential limits on large exposures. In particular, a further degradation of the financial position of the Delta group beyond what has already been recognized could have systemic implications due to CRSM's exposure.

Financial sector regulation and supervision

- The CBSM's governance needs to be enhanced, with a view to strengthen its accountability and independence. Its budgetary arrangements need to be strengthened so as to enhance its operational autonomy.

- The CBSM has created a regulatory regime that approaches international standards, with gaps notably in international cooperation, with legal provisions on secrecy constraining its scope; the absence of provisions for specific capital requirements for market and operational risks; and five year transitional provisions with regard to limits to large exposures and connected lending. The fiduciary firms need to be more tightly regulated.

- The CBSM capacity is weak, especially in the area of supervision (i.e., supervisory manuals for on-site and off-site supervision have not been finalized, and there is no policy with regard a desirable periodicity for on-site inspections). Particular attention is needed with the enforcement of banks' obligations with regard to financial crime.

Anti-money laundering and combating the financing of terrorism (AML/CFT)

- Following the 2007 MONEYVAL mutual evaluation, the authorities acted swiftly and steadily to fix the shortcomings and fill the gaps of the AML/CFT regime, leading to the lifting of the compliance enhancing procedure in September 2009.

- Effective implementation of the AML/CFT regime remains a challenge, partly due to the short timeframe in which financial institutions had to cope with the new regulatory framework, but also because of the ineffectiveness of the previous regime and scarce controls. More human resources should be allocated to the Financial Intelligence Agency, the CBSM and the Judiciary.

- Mechanisms to ensure transparency in the ownership of fiduciary companies should be enhanced and the scope of the activities in which fiduciary companies can engage should be clarified.

Source: Financial Sector Stability Assessment.

8. **Several features of the economy of San Marino should help in addressing current challenges.** The economy is not as dependent on the financial sector as is often thought, a positive feature if financial sector activities were no longer to drive growth. Industry has the largest contribution to GDP (38 percent); tourism and commercial sectors are also important, contributing together nearly 20 percent; financial activities contribute for about 19 percent (Figure 1). Furthermore, the financial sector employs only about 5 percent of the work force, and its contribution to total government's revenues (about 10 percent) is large but not dominant (Figure 3). Finally, owing to prudent fiscal policy over the years, the public sector had accumulated significant deposits, equivalent to about 23 percent of GDP as of October 2009.

II. Policy Discussions

9. **Discussions focused on policies to mitigate macro-financial vulnerabilities and support growth; they benefited from the conclusions of the FSAP**. The policy objectives of the authorities are to: (i) ensure an orderly unwinding of the banks' position in the context of the Italian tax amnesty through skillful liquidity management and enhanced international cooperation, in particular with Italy; (ii) support the economy through appropriate fiscal policy without endangering medium-term sustainability; (iii) strengthen the institutional framework for the CBSM's LOLR function; and (iv) clarify the business environment and financial sector supervision to support a repositioning of the economy.

A. Policy Response to Short-Term Challenges

10. **The authorities' response to the short-term challenges comprises fiscal and financial sector policy measures (including with regard to the AMF/CFT regime)**. While some actions started in late 2008, the bulk of the measures were implemented in the second half of 2009, at a time when the impact of the global crisis on the economy, and of the Italian tax amnesty on the financial sector was becoming more evident.

Fiscal policy

11. **To contain the effect of the downturn on the economy the government has taken several fiscal measures.** A scheme to subsidize enterprises planning to invest in new technologies was introduced in 2009. This scheme took the form of an interest subsidy on bank loans of up to 10 years to finance investments of up to 5 million euros per enterprise, with an overall envelop of 100 million euros. The subsidy covers up to 80 percent of the interest payments; applications need to be submitted by December 31, 2009 but the Government is planning to extend this deadline up to March 31, 2010. The Government has also expanded unemployment benefits to fixed-term unemployed workers and workers employed in the services sector based on the length of past employment. Wage supplementation benefits (*Cassa Integrazione Guadagni*), provided when wage payments are interrupted due to temporary market disruptions, were also extended for an additional

3 months until December 31, 2009. The Government intends to implement a more comprehensive reform of social safety nets in 2010.

12. **The above discretionary measures, together with the sharp contraction in revenues from the economic slowdown, will result in a significant deterioration of the fiscal accounts.** The central government balance is expected to be -4.3 percent of GDP in 2009 —the first deficit since 2002— and -3.5 of GDP in 2010. The overall balance of the consolidated public sector will reach -6.2 and -5.5 percent of GDP in 2009 and 2010, respectively, partly due to the widening deficit of the Social Security Institute. The latter reflects higher expenses on social safety nets and lower contribution rates from the weaker labor market.

Financial sector policies

13. **The CBSM took several steps to enhance its ability to monitor the liquidity position of banks during the course of 2009**. Banks were asked to report their liquidity position frequently—eventually on a daily basis—and to disclose the maturity structure of their balance sheets. These measures allowed the CBSM to respond flexibly to short-term liquidity developments.

14. **Several initiatives were also taken, some in close cooperation with the Italian authorities, to ease liquidity pressures and boost CBSM's LOLR capacity**:

- In response to liquidity pressures that started to build up at the CRSM following the June 2009 events, the CBSM provided liquidity assistance, which was supplemented by a credit line from a local bank; this liquidity was utilized to support Delta. Concurrently, the pool of Italian banks participating in the funding of Delta agreed to maintain their exposure up to the end March 2010;

- Measures to boost CBSM's LOLR capacity were three fold: (i) in mid-November 2009 the CBSM established a voluntary and incentive-based facility whereby banks with excess liquidity could deposit funds with the CBSM; (ii) at the end of November 2009 a Decree-Law allowed the government to guarantee any foreign borrowing by the CBSM to help secure credit lines from domestic or foreign banks to be used for liquidity assistance for financial institutions faced with a temporary need;[2] (iii) in early December 2009 a Decree-Law imposed on banks a mandatory 8 percent deposit requirement with the CBSM. The CBSM informed financial institutions that any liquidity assistance provided to another bank would be taken into account in the

[2] The incentive-based facility set up by the CBSM did not generate an interest on the part of the banks. Regarding foreign borrowing, discussions were held in late November on the possibility of setting up a government guaranteed credit line from a pool of Italian banks; these discussions ended without result.

computation of the funds required to be deposited with the CBSM.[3] The authorities have indicated that the measure has contributed to an appropriate redistribution of liquidity in the system; and

- In early December 2009, Italy's Revenue Agency, recognizing San Marino's particular situation, responded positively to San Marino's request to consider a possible extension for the effective repatriation to Italy of funds benefiting from the tax amnesty and granted an extension to June 30, 2010.

15. **A recapitalization plan is being implemented to boost the financial strength of the largest bank**. In mid-January 2010, the shareholders of the CRSM unveiled a plan to strengthen its financial position which had suffered from its exposure to Delta, involving: (i) an overall 100 to 150 million in capital injection, with contributions from the government, the local banking sector, Sammarinese private investors, and the current shareholders; and (ii) issuance of medium term bonds. The CRSM indicated that the plan would bring the bank's CAR above 11 percent, which will be the minimum requirement by 2013.

16. **With regard to the AML/CFT regime, since the adoption of the MONEYVAL Mutual Evaluation Report in 2008, San Marino has achieved considerable progress in bringing its legal and institutional framework in line with the FATF recommendations**. As a result of this progress MONEYVAL lifted the compliance enhancing procedure in September 2009. However effective implementation of the AML/CFT requirements remains a challenge, especially with regard to customers accepted prior to the enactment of the new AML/CFT law. An on-site visit of San Marino is planned in September 2010, as part of MONEYVAL's fourth round of mutual evaluations.

B. Addressing Medium-Term Challenges

17. **The authorities have started to take action in response to medium-term challenges, but this is still a largely unfinished agenda.** So far, the authorities have mainly focused on policy measures to strengthen transparency and international cooperation in economic and financial matters. The reform agenda to strengthen fiscal sustainability and increase labor and product market flexibility in response to medium-term challenges needs to be spelled out, and reforms to strengthen the institutional framework for the LOLR function are still at an initial stage.

[3] The measure differs from a standard reserve requirement system in several ways: it is of a temporary nature and shall end in January 2010; it applies to interbank deposits as well as customer deposits; deposits required to be held with the CBSM will be blocked for the whole (monthly) maintenance period; derogation to the general requirement may be granted based on demonstrated liquidity stress.

Business environment and financial sector reform

18. **Important steps were taken by the government in 2009 to improve the business environment, by enhancing transparency in economic and financial matters, as well as international cooperation**. Between April and September 2009, San Marino signed 12 OECD compliant bilateral agreements on exchange of information on tax matters, allowing the country to join the OECD "White List".[4] At the regional level, Economic and Financial Cooperation agreements were signed with Italy. These initiatives will serve as foundations upon which the economy can reposition itself in the new international environment of greater transparency.

19. **A renegotiation of the 2000 Monetary Cooperation agreement with the European Community is already in motion**. The European Commission is now asking San Marino to adopt over time all relevant EU legislation relating to the activity and supervision of financial institutions, AML/CFT, and statistical reporting requirements. The ultimate objective is to create a level playing field between San Marino and the European Community for its financial sector. In this context, in November 2009 San Marino also raised the possibility for its banks to access Eurosystem liquidity, although this is not envisaged in the decision adopted by the Council on the renegotiation of the agreement.

20. **The FSAP noted that, starting from a low base, in the recent period commendable progress was made by the CBSM in strengthening the prudential and supervisory frameworks.** Prior to 2005, financial regulation in San Marino was very limited, with virtually no regulation consistent with the Basel Committee Core Principles for Effective Banking Supervision. Over the past four years, the CBSM has been the main driver in the development of a proper regulatory regime which now approaches international standards. However, supervisory and enforcement capacity (especially on-site supervision) is weak and the CBSM needs greater autonomy and additional resources to be able to discharge effectively its functions, including to conduct full inspections.

Product and labor market reform

21. **Measures to support private investment and innovation have been implemented.** Reduced import tax rates[5] on instrumental goods were introduced in 2004, and tax benefits on reinvested operating profits were established in 2007.

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[4] This effort is continuing, with eight additional bilateral agreements signed as of mid-January 2010.

[5] A distinctive feature of the Sammarinese tax system is the import tax (known as *monofase*), a single-stage indirect tax levied on goods intended for domestic consumption and reimbursed each time imported goods are subsequently re-exported. At the moment this *monofase* is the most important indirect tax, although the government has indicated the intention to eventually replace it with a VAT system.

22. **The government has taken important steps toward product market liberalization and streamlining, but some barriers to competition remain**. The business licensing system has been reformed in 2009, with the aim of reducing political discretion in awarding licenses, expediting bureaucratic procedures and reducing barriers to entry. Measures have also been taken to discourage the establishment of anonymous companies and increase transparency. However, the authorities consider that restrictions on ownership and entry barriers should remain in those sectors (i.e., real estate, telecommunication and car rental) which are particularly vulnerable to money-laundering activities.

23. **The labor market rigidities mentioned in previous Article IV consultations remain significant, as well as are the restrictions on the hiring of nonresident workers.** Measures to liberalize the labor market have been piecemeal, resulting in continued hurdles for the hiring of non Sammarinese highly-skilled workers. The labor market also suffers from the absence of a double-taxation agreement with Italy, which is a deterrent to foreign workers. The government is now planning several reforms to strengthen the labor market. In particular, it intends to implement active labor market policies to assist unemployed workers and enhance employability, and further streamline the system of social safety nets. However, reservations were expressed regarding increasing labor market liberalization.

Public administration reform

24. **An ambitious plan of public administration reforms has been launched to increase flexibility and productivity**. Public administration in San Marino has traditionally been excessively bureaucratic, with an oversized number of employees, at times deficient in terms of education and skill levels. Recently approved laws envisage more flexibility in moving employees and managers within the public administration and assigning tasks, enhanced autonomy and accountability for managers, higher education requirements for new employees and more transparency in the hiring process.

25. **The government is also planning a number of state owned enterprises reforms.** These reforms include the transformation of the public utility and the postal service firms into a state joint stock company, the conversion of the philatelic and numismatic corporation into a special accounting office, and the University into a foundation, and the privatization of the diary company. In the utility sector the government is considering adjusting tariffs more in line with market prices, and move to a more cost effective procurement system.

III. Staff Appraisal

Short-term macro financial vulnerabilities

26. **The mission broadly endorses the authorities' policies to address immediate pressures on the financial sector, and notes that significant vulnerabilities remain.** The

authorities' pro-active stance and skilful management in dealing with the emerging liquidity pressures, combined with the cooperation of the Italian authorities, is helping to facilitate the orderly unwinding of the banks' positions. The extension of Italy's tax amnesty to April 30, 2010 could potentially lead to new pressures in particular on the largest bank. Therefore, it is desirable to maintain the safeguards and controls adopted by the CBSM; as soon as the liquidity pressures on Sammarinese banks abates, the CBSM should consider eliminating the mandatory deposit requirement system and implement a reserve requirements system in line with best practice. The authorities' prompt action in dealing with pressures on the financial position of the largest bank (CRSM) is also to be commended, and staff notes that these measures, once implemented, would enhance its financial strength. However, a degradation of the financial position of the Delta group well beyond what has already been recognized could lead to recapitalization needs for the CRSM exceeding the capacity of its current or potential Sammarinese shareholders, therefore requiring the authorities to give consideration to opening its capital to other investors.

27. **Short term fiscal policies to support the economy during the current slowdown are broadly appropriate, but a consolidation strategy should be planned ahead.** While current deficits are driven by cyclical conditions, even after the recovery, public finances will face challenges from ageing and healthcare related liabilities and potential costs related to the planned reform of active labor market policies. There may also be a loss in revenues due to lower financial sector profitability and a decline in the growth potential of the economy.

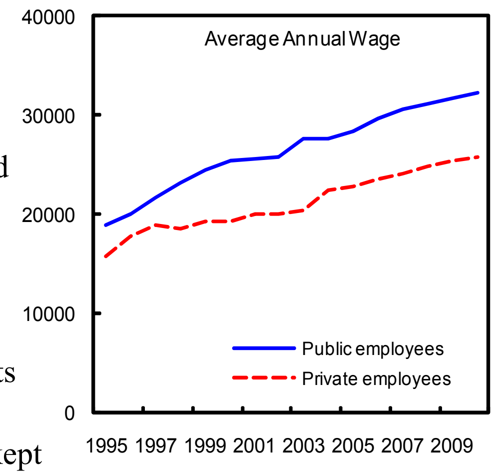
Overall strategy for repositioning the economy

28. **San Marino is now at a critical juncture and the pressure for reform creates a window of opportunity that the authorities should not miss**. The mission commends the government's medium-term policy objectives. In particular, the authorities' aim to facilitate the transformation of the country's business model through enhanced international cooperation and transparency is appropriate.

29. **The impetus given by the government to strengthening cooperation with Italy is to be commended.** The Economic Cooperation agreement and the Financial Cooperation agreement are key building blocks this strategy. The latter agreement outlines the conditions for San Marino banks to be granted direct access to the payment systems of the EU, and the authorities should act swiftly to take advantage of this. This agreement also opens the way for the signature of Memorandum of Understanding (MOUs) for the exchange of information between the CBSM and the Bank of Italy, and between the agencies responsible for AML/CFT and for the prevention of market abuses, another area where the authorities should move swiftly as it would strengthen cross-border oversight of the financial sector and facilitate cooperation in dealing with emerging problems. Early signature of the Double Taxation agreement—the third building block in the strategy—is also desirable as it would improve further the business environment by facilitating the hiring of high-skilled workers from Italy.

Ensure fiscal sustainability

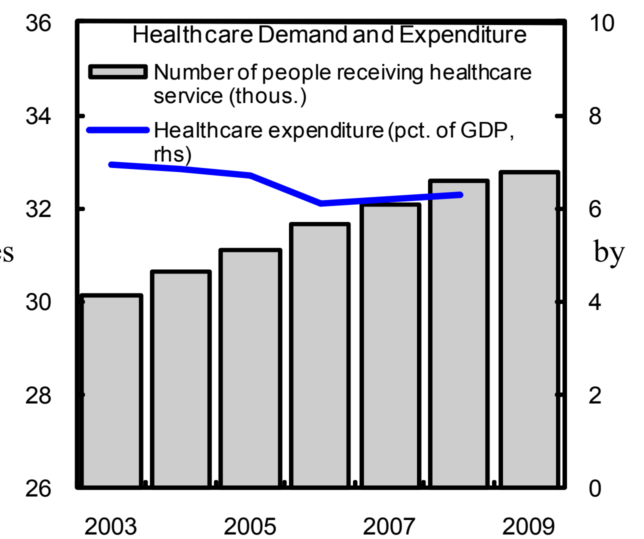
30. **Fiscal adjustment should rely on reducing current expenditure**, which accounts for over 80 percent of total spending, including state transfers to rest of the public sector and wage bills. Recent initiatives in the area of public administration reform and more responsible public sector wage negotiations are important steps in the right direction. However, given that average public sector wages remain well above those in the private sector further public sector wage increases should be contained. Also, the social safety nets reform, including new active labor market policies, is likely to create new budget costs which will need to be kept under control.



Source: National authorities.

31. **Pension reforms should resume.** The 2005 pension reform has resulted in a significant increase in contributions that overall are now in line with benefits. Nevertheless, certain pension funds are constantly in deficit, requiring subsidization from other funds, as well as frequent extraordinary transfers from the state budget. Moreover, actuarial projections suggest that the current system is not sustainable in the long term. Building on the consensus that the 2005 reform has generated, additional measures should be considered, including: (i) harmonizing contribution rates across categories of workers, to avoid cross-subsidization; (ii) increasing contributions rates; (iii) lengthening of the period over which qualifying wages are considered in the determination of pension benefits; and (iv) expediting the introduction of a fully funded second pillar. The current rule under which state transfers are automatically linked to total contributions could also be reconsidered, as it implies a steady and automatic increase in central government pension expenditure.

32. **Recent initiatives to limit the reliance of the healthcare budget on state transfers should continue.** While steps have been taken to boost healthcare revenues by offering services to non-residents upon payment, the demand for health services is growing rapidly and health expenditure in percent of GDP has been increasing since 2006, and is expected to climb further according to the 2010 budget. Therefore, it



Sources: National authorities; and IMF staff calculations.

may soon become necessary to introduce co-payments on selected services and pharmaceutical products.

Strengthen the LOLR framework and financial sector supervision

33. **The institutional framework for liquidity management in San Marino needs to be strengthened**. The lack of an effective LOLR facility makes San Marino's banking sector susceptible to a risk of insolvency triggered by liquidity pressures, which in turn could lead to strains on the public finances and economic growth. To mitigate macro-financial vulnerabilities the institutional framework for systemic liquidity management needs upgrading and the mission supports the authorities in their efforts to explore the feasibility to secure access to Eurosystem liquidity for Sammarinese banks in the context of the renegotiation of the 2000 Monetary Cooperation agreement. In the meantime, and as a first line of defense, the CBSM should strengthen self insurance mechanisms to help banks cope better with idiosyncratic liquidity shocks by ensuring that banks are properly assessing their own liquidity mismatches and setting appropriate limits for their circumstances. Banks should also be asked to seek credit lines from reputable and dependable international banking groups; those unable to do so could be required to hold a larger stock of liquid assets.

34. **Financial sector supervision should be further reinforced in order to create, over time, a level playing field with the European Community**. The conclusions of the FSAP suggest that, while challenging, this objective is not out of reach. The CBSM will need to strengthen its governance so as to enhance its autonomy; its resources will need to be expanded to facilitate the effective enforcement of prudential regulations and supervision; and its international cooperation with related institutions abroad needs to be intensified. Furthermore, while the authorities have shown a serious commitment to AML/CFT and have achieved considerable progress in bringing San Marino's legal framework in line with international standards, additional resources need to be allocated to the Financial Intelligence Agency (FIA), the CBSM and the judiciary to improve enforcement.

35. **More broadly, the authorities need to evaluate what kind of financial sector is best suited for San Marino.** In the absence of a LOLR, a smaller scale financial sector focused on the needs of the economy of San Marino would be prudent. On the other hand, if the banking sector were better integrated with reputable and dependable international banking groups than is currently the case, this would lessen the need for a Sammarinese specific LOLR framework, and the financial sector could remain large and internationally active. This model would be based on the development of a financial sector in which the soundness of locally-licensed banks would depend on that of their parent institutions. The need to maintain strong financial sector regulation and supervision capacities would nevertheless remain, partly because support from parents cannot be taken for granted. In this context, the challenge would be to balance prudential requirements for liquidity and exposure to related parties against business needs that entail high exposures to the parent. This would

require close cooperation with home supervisors in order to keep under review the financial health of parent groups and their ability to support their local subsidiaries.

Enhance product and labor markets flexibility

36. **The staff welcome the efforts to liberalize the product market, but reckons that the authorities' concerns can be addressed through measures less damaging to competition.** Remaining restrictions to ownership and entry barriers could be removed given that concerns about the potential for money-laundering for certain activities may be addressed through the implementation of an effective AML/CFT regime, on corporate ownership in particular.

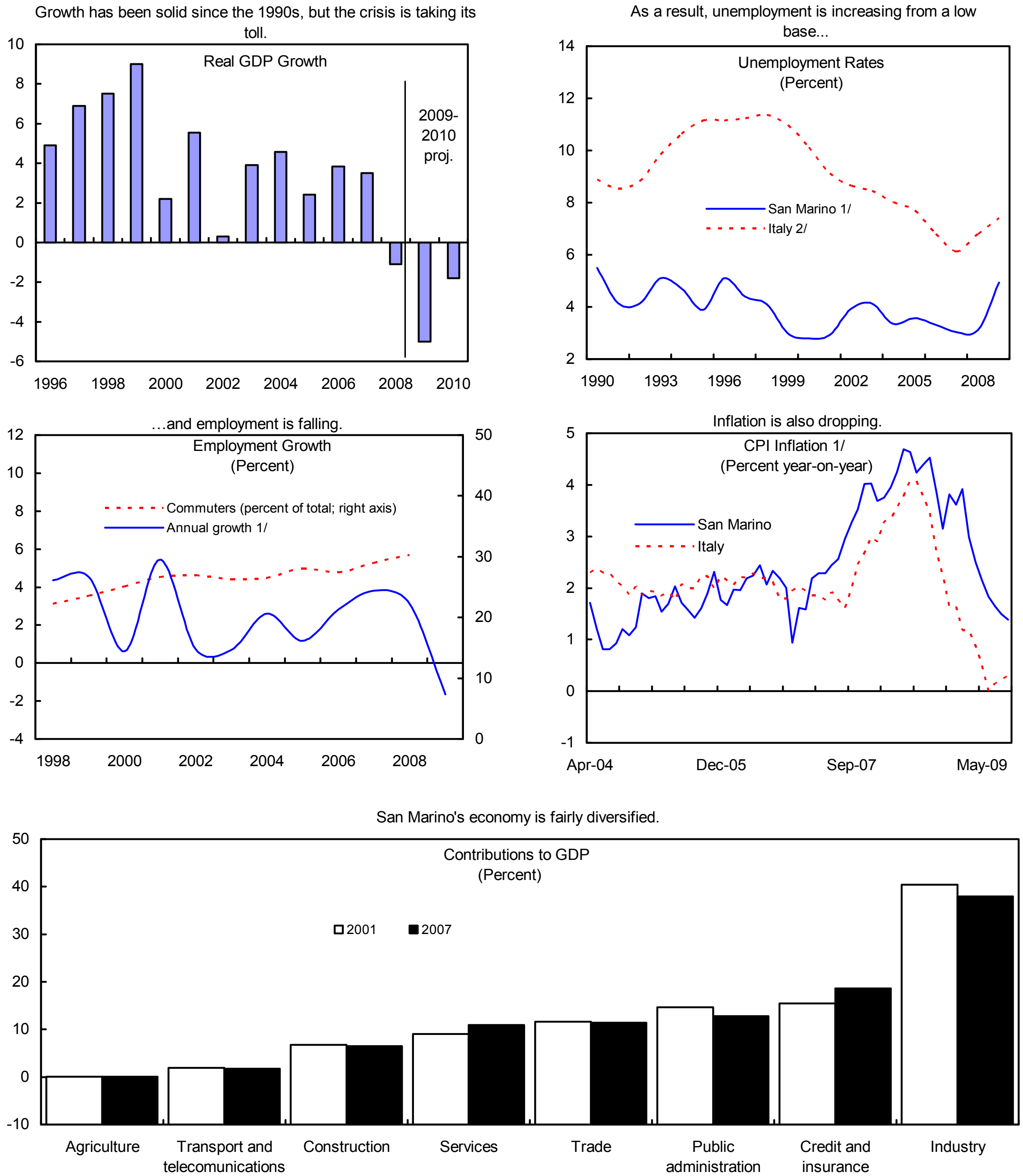
37. **Labor market reforms are needed to attract more diversified and high-skilled labor and ease the transition toward a new business model.** The mission acknowledges that active labor market policies can help generate the jobs that the private sector will need to reposition itself in the new environment however, their actual effectiveness remains to be seen. Moreover, labor market rigidities continue to be high, making it difficult for the private sector to take advantage of new market opportunities. The mission also understands that undertaking wide-ranging reforms when pressures on unemployment have increased is politically challenging, but an open and competitive labor market will be in the long-run interest of the citizens of San Marino.

Strengthen further the statistical system

38. **The authorities have made great strides since San Marino's participation in the IMF's General Data Dissemination System, but there is still room for improvement (Annex II)**. National and fiscal accounts, as well as monetary and financial sector data are compiled according to international standards, but some key statistics (such as real and fiscal data) are available only with delay and, in many cases, are at a lower than standard frequency and detail, which raises uncertainty about the reliability of medium term forecasts. Increasing coverage and reducing the time lag in producing and disseminating statistics would help bring the system to a level needed for well informed economic policymaking. An improved and more timely statistical database would also help San Marino achieve its aim of greater international integration.

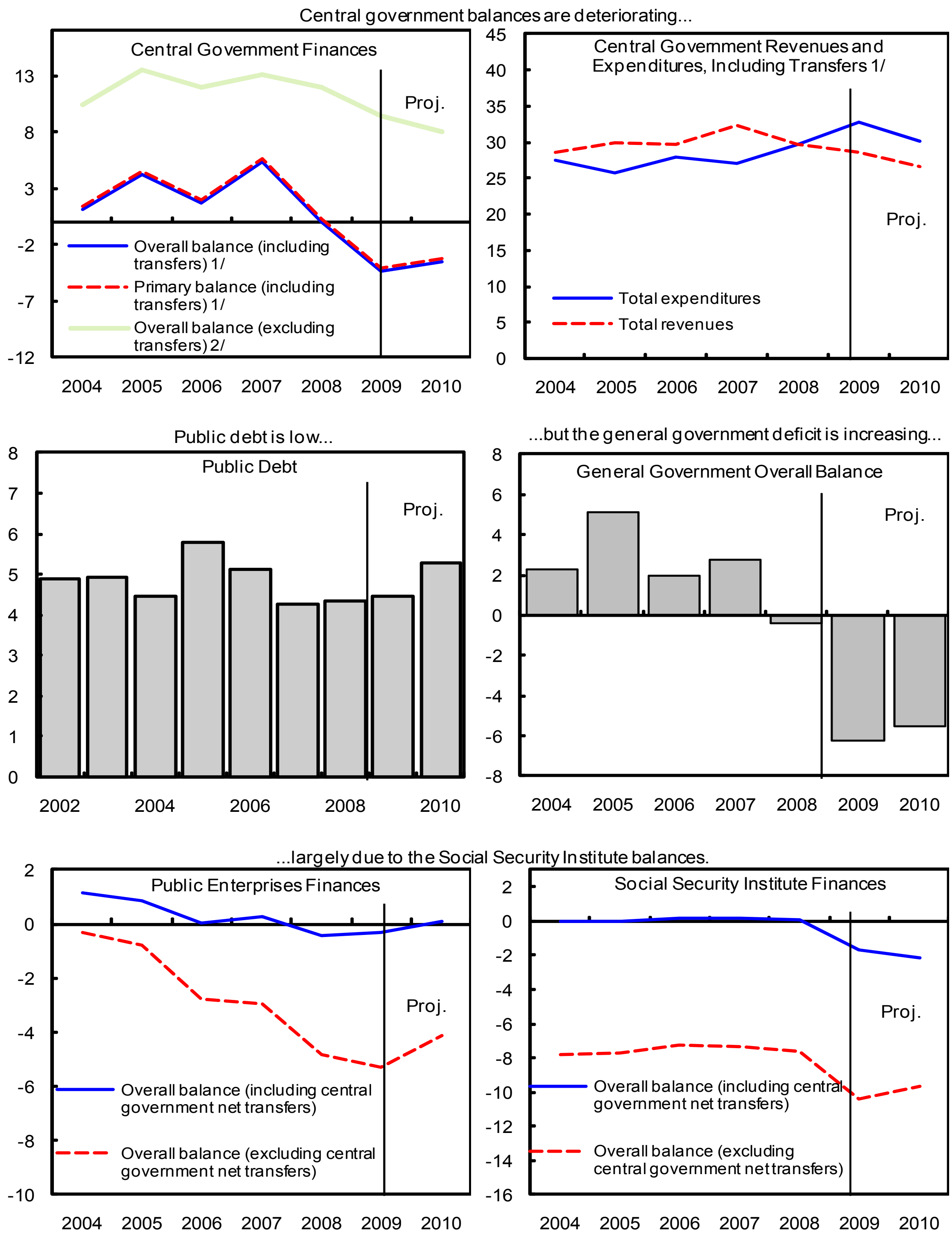
39. It is recommended that San Marino remain on a 24-month consultation cycle.

Figure 1. San Marino: Real Sector Developments



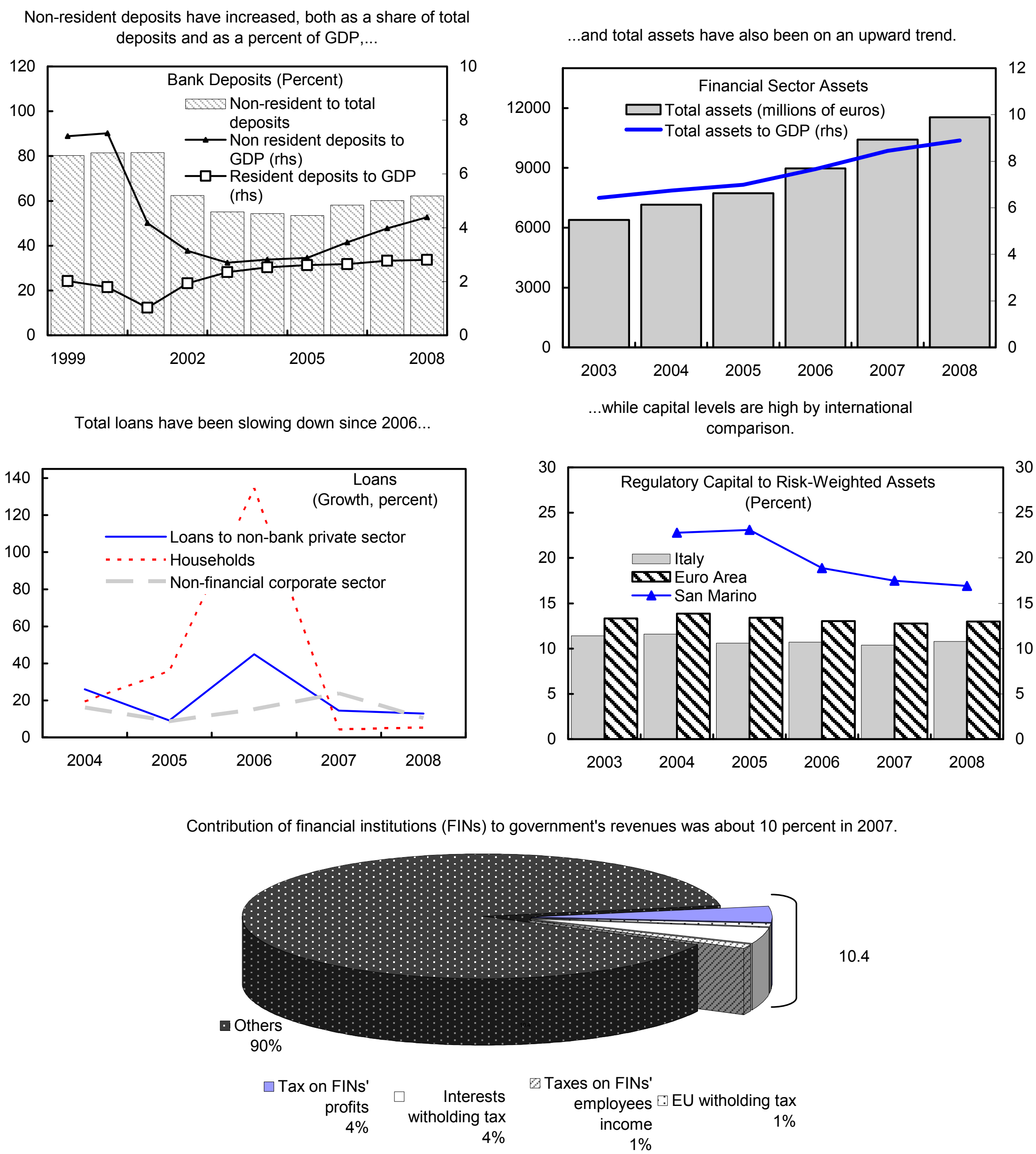
Sources: Sammarinese authorities; ISTAT; and IMF staff estimates.
1/ Data as of October 2009.
2/ Data as of June 2009.

Figure 2. San Marino: Fiscal Sector Variables
(Percent of GDP)



Source: National authorities; and IMF staff calculations.
1/ Including net transfers to the rest of the public sector.
2/ Excluding net transfers to the rest of the public sector.

Figure 3. San Marino: Financial Sector Variables



Sources: Central Bank of San Marino; and IMF staff calculations.

Table 1. San Marino: Selected Economic and Social Indicators, 2004–10

(Percent, unless otherwise indicated)

	2004	2005	2006	2007	2008	Latest reading		2009	2010
								Proj.	
Selected Economic Indicators									
(Annual percentage change, unless indicated otherwise)									
Output and prices									
Real GDP	4.6	2.4	3.8	3.5	-1.1			-5.0	-1.8
Employment	2.8	1.2	1.7	3.2	3.5	-1.2	Nov-09	-1.5	-0.7
Unemployment rate (end of year; percent)	3.4	3.6	3.3	3.0	3.1	4.7	Nov-09	5.1	5.5
Inflation rate (average)	1.4	1.7	2.1	2.5	4.3	1.8	Nov-09	2.4	2.7
Nominal GDP (millions of euros)	1061.4	1105.7	1170.9	1232.8	1259.0			1214.0	1214.5
(Percent of GDP)									
Central government									
Overall balance	1.2	4.3	1.8	5.4	0.0			-4.3	-3.5
Primary balance	1.5	4.5	2.0	5.7	0.3			-4.1	-3.2
Gross debt	4.5	5.8	5.1	4.3	4.2	4.4	June-09	4.4	5.3
(Percent of GDP, end of period)									
Net foreign assets									
Deposit money banks	61.15	72.12	18.16	22.23	3.07	…			
Central bank	24.54	27.14	31.07	35.69	39.16	…			
(Percent of GDP, unless indicated otherwise)									
External accounts									
Trade balance 1/	-4.1	-3.7	-0.3	2.4	15.7	…		17	20
Exports 1/	186.1	184.0	197.0	202.1	222.5	…		215	220
Imports 1/	190.2	187.7	197.3	199.6	206.8	…		198	200
Gross international reserves (millions of U.S. dollars)	355.6	354.0	479.1	647.8	706.8	…			
Number of tourists (millions)	2.14	2.11	2.14	2.16	2.11	1.95	Nov-09		
Exchange Rate	The euro is the official currency of San Marino								
Financial Soundness indicators									
Capital adequacy ratios									
Regulatory capital to risk-weighted assets	22.8	23.1	18.9	17.5	16.9	15.4	June-09		
Asset quality ratios									
Nonperforming loans to total loans	1.0	2.2	1.9	2.1	2.4	2.4	June-09		
Provisioning to total loans	5.0	4.4	4.5	4.7	2.7	2.8	June-09		
Provisioning to total NPLs	499.6	205.5	240.2	226.7	113.8	113.7	June-09		
Earning and profitability									
Return on assets (ROA)	0.8	0.2	0.9	1.2	0.8	0.3	June-09		
Return on equity (ROE) 2/	6.7	2.0	8.4	10.7	7.6	3.1	June-09		
Return on equity (ROE) 3/	5.1	4.1	7.9	12.1	10.0	2.9	June-09		
Interest margin to gross income	48.2	47.8	46.9	43.9	43.5	44.3	June-09		
Non-interest expenses to gross income	23.1	22.9	20.9	18.3	17.7	20.5	June-09		
Salary expenditures to non-interest expenditures	89.1	89.9	89.9	91.5	92.1	94.2	June-09		
Social Indicators									
Land area (2008)	23.5 sq mi								
Population, total (2008)	29,973								
Life expectancy at birth, total (2006)	82.2								
Life expectancy at birth, male (2006)	79.4								
Life expectancy at birth, female (2006)	85.1								
Infant mortality rate per 1,000 live births (2007)	3.5								
Population per sq. km of land area (2008)	1,225/sq mi								

Sources: Sammarinese authorities; World Bank; and IMF staff estimates.

1/ Based on national account data.

2/ Before extraordinary items and taxes.

3/ After extraordinary items and taxes.

Table 2. San Marino: Structure of the financial system

	2003	2004	2005	2006	2007	2008	2009 1/
Number							
Banks	10	11	12	12	12	12	12
o/w foreign-majority owned	6	7	8	7	6	6	6
Insurance companies (life)	0	0	0	0	0	0	2
CIS/management companies	0	0	0	0	5	9	11
Financial system assets (in millions of euro)							
Banks	6,397	7,155	7,723	8,976	10,415	11,536	11,697
o/w foreign-majority owned	2,268	2,625	3,154	3,218	3,798	4,414	4,650
Insurance sector	0	0	0	0	0	0	25
CIS/management companies	0	0	0	0	38	37	39
Total financial system assets 2/	6,397	7,155	7,723	8,976	10,453	11,573	11,761
Assets as percent of total financial system							
Banks	100	100	100	100	99.6	99.7	99.5
o/w foreign-majority owned	35.4	36.7	40.8	35.9	36.3	38.1	39.5
Other non-bank institutions	0	0	0	0	0.4	0.3	0.5
Assets as percent of GDP							
Banks	…	…	698	767	853	871	…
o/w foreign-majority owned	…	…	285	275	311	333	…
Other non-bankinstitutions	…	…	0	0	0.03	0.024	…

Source: Central Bank of San Marino.

1/ As of June 2009

2/ Figures do not include data on other non-bank financial institutions like fiduciaries, leasing, and factoring companies.

Table 3. San Marino: Public Finances, 2004–10 1/

(Percent of GDP)

	2004	2005	2006	2007	2008	2009	2010
						Proj.	
Central administration operations							
Revenues 2/	28.7	30.0	30.0	32.6	29.8	28.5	26.7
Tax	21.6	23.3	24.3	26.9	24.1	22.6	21.3
Direct 2/	9.7	10.1	9.3	9.1	9.2	8.3	7.5
Import tax 2/	9.2	10.0	10.5	13.1	10.1	9.6	9.4
Other indirect taxes	2.7	3.3	4.4	4.7	4.7	4.7	4.4
Non-tax 2/ 3/	7.1	6.6	5.7	5.7	5.7	6.0	5.4
Expenditure	27.5	25.7	28.2	30.3	29.7	32.8	30.1
Current expenditure	24.4	23.6	25.8	26.5	24.9	27.3	25.4
Wages and salaries	9.0	9.0	8.8	8.8	8.9	9.9	10.1
Transfers to public sector	11.1	10.9	10.7	10.6	11.0	12.3	10.8
Of which: ISS	7.8	7.7	7.4	7.6	7.7	8.8	7.5
Transfers to private sector	0.7	0.8	1.0	1.0	1.1	1.2	1.0
Interest payments	0.3	0.3	0.3	0.3	0.3	0.2	0.3
Others 4/	3.3	2.7	5.0	5.9	3.6	3.6	3.1
Capital expenditure	3.1	2.0	2.4	3.8	4.8	5.5	4.8
Transfers to public sector	0.7	0.7	0.9	1.7	2.3	3.0	2.4
Others	2.4	1.3	1.5	2.1	2.6	2.6	2.4
Balance (including transfers)	1.2	4.3	1.8	2.3	0.0	-4.3	-3.5
Financing	-1.2	-4.3	-1.7	-2.3	0.0	4.3	3.5
Net debt financing	1.0	-0.5	-0.5	-0.3	-0.3	-0.1	0.8
Change in deposits	-5.3	-1.7	-4.9	-1.8	-3.9	-2.0	0.3
Change in net government arrears	2.5	-2.5	3.4	3.3	-0.2	5.6	2.0
Asset sales	0.7	0.3	0.2	0.0	0.2	0.8	0.4
Consolidated government							
Overall balance of the consolidated government (excluding transfers)	2.3	5.2	2.0	2.8	-0.4	-6.2	-5.5
Central administration operations (excluding transfers)	10.4	13.6	12.0	13.1	12.0	9.5	8.1
Public enterprises (excluding transfers)	-0.3	-0.8	-2.8	-3.0	-4.8	-5.3	-4.1
Social security fund (excluding transfers)	-7.8	-7.7	-7.3	-7.3	-7.6	-10.4	-9.6
Memorandum items:							
Public debt	4.5	5.8	5.1	4.3	4.3	4.4	5.3
Nominal GDP (millions of euros)	1,061	1,106	1,171	1,233	1,259	1,214	1,214
Real GDP growth (year-on-year percent change)	4.6	2.4	3.8	3.5	-1.1	-5.0	-1.8
Change in GDP deflator (year-on-year percent change)	2.0	1.8	1.9	1.7	3.2	1.5	1.9
Overall balance of public enterprises (including transfers)	1.1	0.9	0.0	0.3	-0.5	-0.3	0.1
Overall balance of social security fund (including transfers)	0.0	0.0	0.2	0.2	0.1	-1.7	-2.1

Sources: Sammarinese authorities; and staff estimates.

1/ Projections for 2009-10 are partly based on authorities estimates and the 2010 budget.
2/ Net of tax reimbursements.
3/ Includes custom duties, state monopolies, other special revenues, revenues from financial assets, interests on credits and deposits.
4/ Includes purchases of goods and services, remunerations for consultancies, contribution to interest payments on publicly subsidized loans, and transport cost.

INTERNATIONAL MONETARY FUND

SAN MARINO

Staff Report for the 2009 Article IV Consultation—Informational Annex

Prepared by the European Department

February 2, 2010

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ANNEX I. SAN MARINO: FUND RELATIONS
(as of November 30, 2009)

- **Article IV mission**: November 13–23, 2009.
- **Staff team:** B. Laurens (head), E. Zoli and V. Flamini (all from EUR). B. Gonzalez Hermosillo (MCM) led the overlapping Financial Sector Assessment Program (FSAP) team.
- **Key country interlocutors**: Secretary of State for Finance and Budget, Secretary of State for Foreign Affairs, President and Director General of CBSM, other senior public sector officials, labor union and private sector participants. A press conference was held at the end of the mission.
- **Data:** San Marino began participating in the Fund's General Data Dissemination System on May 16, 2008, making at the time a major step forward in the development of its statistical system. However, data shortcomings remain (Annex II).

I. **Membership Status**: San Marino joined the IMF on September 23, 1992 and accepted the obligations of Article VIII of the Articles of Agreements.

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
	Allocation	15.53	100.00
	Holdings	16.68	107.40

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

V. **Financial Arrangements**: None

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

VII. **Exchange Rate Arrangements**: Prior to 1999 the currency of San Marino was the Italian lira. Since January 1, 1999 San Marino uses the euro as its official currency. The central monetary institution is the Banca Centrale della Republica 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's exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).[1]

VIII. **Article IV Consultation**: San Marino is on a 24 months cycle. The previous Article IV consultation took place during November 30–December 11, 2006, and concluded on February 23, 2007 (Country Report No. 07/94). The staff report and associated Executive Board's assessment are available at:
http://www.imf.org/external/pubs/cat/longres.cfm?sk=20491.0

IX. **Technical Assistance**

Year	**Dept. Purpose**	**Date**
1997	STA Multisector assistance	3/97
2004	STA Monetary and Financial Statistics	1/29–2/4
2005	MFD Deposit insurance	11/05
2008	STA GDDS metadata development	03/08
2008	LEG AML/CFT	11/08

X. **Resident Representative**: None.

[1] EU Regulations are not directly applicable to San Marino as a result of Article 249 of the Treaty Establishing the European Community, but they may well be applied as a result of the legal relationship between San Marino and Italy, acting on behalf of the European Union.

ANNEX II. SAN MARINO: STATISTICAL ISSUES

Data provision: Progress has been made since San Marino's participation in the IMF's General Data Dissemination System (GDDS) in May 6, 2008 but important weaknesses in the statistical database remain mainly due to resource constraints. In January 2007, in view their intention to participate to the GDDS, the authorities named two National GDDS Coordinators and announced their objective to increase the frequency of website updates in order to improve data dissemination. As of November 2009, national and fiscal accounts, as well as monetary and financial sector data are compiled according to international standards but some key statistics (such as real and fiscal data) are available only with delay and, in many cases, are at a lower than standard frequency and detail.

Real sector statistics: National accounts data for 1995 onward have been calculated in accordance with ESA95 and since 2008 data are compiled quarterly with about six months delay. The authorities have also calculated sectoral value added annually but data are published with one-year delay. Consumer prices and, starting June 2008, employment data are published monthly with short delay. A business production index based on electricity consumption was launched in 2006. Consumption and business sentiment indexes have been compiled starting 2007 based on annual household and business surveys.

Government finance statistics: The authorities have provided data for the central government, state owned enterprises, and social security fund for 2004–09, as well as the budget for 2010–2012. However, only central government data have been compiled in accordance with IMF standards, and only after explicit request. Typically, the central government budget is still 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.

Monetary and financial statistics: Since May 1997 the authorities have 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 have introduced laws and took some measures to improve coverage and timeliness of banks' reporting. The CBSM has improved sectorization and expanded data collection to cover the offshore asset management activities of banks. The breakdown of deposits (and other assets and liabilities) between residents and nonresidents and the breakdown of short-term credit by public and private sector components are also available. However, there is no broad money survey and data on non-bank financial intermediaries are lacking.

External sector: San Marino does not compile balance of payments accounts. Given the currency union with Italy and the subsequent introduction of the euro, the authorities have not considered this a high priority and have, therefore, not committed the necessary resources. Starting 2008, trade statistics are released quarterly with a lag of about six months.

San Marino: Table of Common Indicators Required for Surveillance

(As of November 30, 2009)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange Rates	11/30/09	11/30/09	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Sept 2009	Nov 2009	Q	Q	Q
Reserve/Base Money	Sept 2009	Nov 2009	Q	Q	Q
Broad Money	Dec 2008	Apr 2009	Q	Q	Q
Central Bank Balance Sheet	Sept 2009	Nov 2009	Q	Q	Q
Consolidated Balance Sheet of the Banking System	June 2009	Nov 2009	Q	Q	Q
Interest Rates[2]	Sept 2009	Nov 2009	D and Q	D and Q	D and Q
Consumer Price Index	Sept 2009	Nov 2009	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	NA				
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2009	Nov 2009	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	2009	Nov 2009	A	A	A
External Current Account Balance	NA [6]				
Exports and Imports of Goods and Services	2008	Nov 2009	A	A	A
GDP/GNP	2008	Nov 2009	A	A	A
Gross External Debt	NA [6]				
International Investment Position	NA [6]				

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[6] Authorities do not compile BOP data and lack the capacity to provide this information to the Fund.

INTERNATIONAL MONETARY FUND

THE REPUBLIC OF SAN MARINO

Staff Report for the 2009 Article IV Consultation with the Republic of San Marino

Staff Supplement

Prepared by the European Department

Approved by Adam Bennett and Thomas Dorsey

February 16, 2010

1. This statement summarizes economic development and policy actions since issuance of the staff report. This information does not change the thrust of the staff appraisal.

2. The President and Director General of the Central Bank of San Marino (CBSM) resigned on February 9, 2010, following the dismissal of the head of banking supervision at CBSM by CBSM's Board of Directors on the recommendation of the Credit and Savings Committee.[1] In their published letter of resignation they mentioned (inter alia) the following reasons for resigning: "interferences and pressures exerted on the central bank to influence its supervisory function;" and "lack of "the necessary conditions for the continuation of our appointment". In public appearances soon after the resignation, the Minister of Finance indicated that the Committee for Credit and Savings is entitled "to give and revoke its confidence to central bank staff", and he reiterated "the government's commitment to strengthen banking supervision." In an official statement sent to Fund Staff, the Minister of Finance declared (inter alia) that "the latest developments will not interrupt the route San Marino has taken toward higher transparency, efficiency and stability of its banking system" and that "the Government intends to initiate a project to strengthen the regulatory structure of the Central Bank and the Financial Information Agency, in order to implement the recommendations of the IMF and converge toward the most efficient international standards on financial supervision" He also indicated that the authorities are already searching for suitable candidates to fill the positions that have been vacated.

[1] Members of the Credit and Savings Committee (CCS) include the Minister of Finance as Chair and a minimum of two to a maximum of four members appointed by Government among its members. The CCS's responsibilities include "policy and guidance" ("indirizzo e orientamento") on "the activity of banking, finance and insurance supervision."

3. On the basis of the information available to the staff at this juncture, the dismissal of the head of banking supervision would not appear to violate Sammarinese law, but does reflect the lack of independence of the CBSM. These events reinforce the importance of strengthening CBSM independence and accountability frameworks, as underscored in the staff appraisal and elaborated on further in the FSSA. Swift action in line with international best practice in this regard will be critical to help lift the uncertainties regarding banking system policy in San Marino that these recent events may generate. Such actions would include—as a matter of urgency—the appointment of a qualified management team for CBSM and of a new head of banking supervision at the CBSM.

4. In January 2010, Parliament adopted, and the Captains Regent promulgated, amendments to the bank secrecy provisions contained in Article 36 of the San Marino financial supervision law which prohibits disclosure of confidential information. However, the amendments do not properly address the key criticisms identified by the mission (see paragraph # 80 of the FSSA). Article 36 still has no exception to the secrecy provision that would allow on-site visits of foreign-owned banks by the home state supervisor. In addition, the amended Article 36 now allows confidential information to be passed to a foreign-owned bank's parent company but only where this is in accordance with San Marino's laws on consolidated supervision. However, those laws still do not provide for proper risk management of a foreign-owned Sammarinese banks by its parent bank.

5. The effort to sign OECD compliant bilateral agreements on exchange of information on tax matters is continuing, with one additional agreement signed since the staff report was issued. This brings to 21 the number of such agreements signed since April 2009.

6. In light of the risks and perceived risks from arising from banking system concerns, the staff now proposed that the next Article IV consultation be held on the standard 12 month cycle.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 10/32
FOR IMMEDIATE RELEASE
February 25, 2010

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

IMF Executive Board Concludes 2009 Article IV Consultation with San Marino

On February 17, 2010 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with San Marino.[1]

Background

The global financial crisis, which began to affect the economy of San Marino in the second half of 2008, is likely to continue to do so in 2009–10. Growth turned negative by 1.1 percent in 2008; it is projected to be minus 5 percent in 2009 and to remain negative in 2010. As a consequence, unemployment is on the rise and inflation is declining. Due to the sharp deterioration in domestic demand, the trade balance is expected to improve.

Short-term vulnerabilities in the financial sector have risen due to exposure of the largest bank to a troubled Italian banking group and to liquidity pressures from a tax amnesty adopted by the Italian government. The authorities have responded with a range of policy measures, which have so far resulted in the orderly unwinding of the banks' positions, but significant vulnerabilities remain.

For the medium-term, the economy of San Marino must adjust to the new international environment of greater transparency, but it is not yet clear how the economy will adapt to the end of activities based on limited bank secrecy.

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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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Executive Board Assessment

Executive Directors noted the significant negative impact of the global economic crisis on San Marino's economy and the macro financial vulnerabilities that the country faces. Directors endorsed the measures taken by the authorities to address the immediate pressures. They commended the authorities for strengthening international cooperation in economic and financial matters and for their effort to reach a double taxation agreement with Italy, which would help facilitate a repositioning of the economy.

Directors noted that the financial sector has withstood pressures relatively well. They commended the authorities for managing effectively the emerging liquidity pressures. However, in light of the continued uncertainties, Directors stressed that the central bank should maintain the safeguards it had adopted. Directors agreed that as soon as liquidity pressures abate, mandatory deposits should be replaced by a conventional reserve requirement system. They noted that recapitalization of the largest bank would enhance its financial strength.

Directors expressed concern about the dismissal of the head of banking supervision at the central bank and the ensuing resignation of its top management. They stressed that these developments impact the effectiveness of financial supervision and undermine the credibility of the reform process in the financial sector and the reputation of the country's financial authorities. Directors called on the authorities to resolve this issue urgently and to take the necessary action to rebuild the reputation and credibility of the central bank and ensure its independence and accountability.

Directors considered the authorities' fiscal policy stance to be broadly appropriate. At the same time, they emphasized the importance of ensuring fiscal sustainability. Consolidation measures should include reducing current expenditures as well as resuming pension reforms and consideration should be given to introducing co-payments on healthcare services and products.

Directors urged the authorities to implement the Financial Sector Assessment Program (FSAP) recommendations to further reinforce financial sector supervision and create a level playing field with the European Union. Noting structural weaknesses in the systemic liquidity management framework, Directors encouraged the authorities to address the lack of an effective lender-of-last resort framework, for example through better integration of Sammarinese banks with reputable international banks.

Directors underscored the need for greater product and labor market flexibility to improve the country's business model. Noting the progress made in the statistical system, they encouraged the authorities to strengthen this effort.

Directors appreciated the transparency measures adopted by the authorities, including on anti-money laundering and combating the financing of terrorism, and urged them to fortify these efforts.

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 and Social Indicators, 2004-2010

								Projections	
	2004	2005	2006	2007	2008	Latest reading	2009		2010
(Annual percentage change, unless indicated otherwise)									
Output and prices									
Real GDP	4.6	2.4	3.8	3.5	-1.1			-5.0	-1.8
Employment	2.8	1.2	1.7	3.2	3.5	-1.2	Nov-09	-1.5	-0.7
Unemployment rate (end of year; percent)	3.4	3.6	3.3	3.0	3.1	4.7	Nov-09	5.1	5.5
Inflation rate (average)	1.4	1.7	2.1	2.5	4.3	1.8	Nov-09	2.3	2.7
Nominal GDP (millions of euros)	1061.4	1105.7	1170.9	1232.8	1259.0			1214.0	1214.5
(In percent of GDP)									
Central government									
Overall balance	1.2	4.3	1.8	5.4	0.0			-4.3	-3.5
Primary balance	1.5	4.5	2.0	5.7	0.3			-4.1	-3.2
Gross debt	4.5	5.8	5.1	4.3	4.2	4.4	June-09	4.4	5.3
(In percent of GDP, end of period)									
Net foreign assets									
Deposit money banks	61.15	72.12	18.16	22.23	3.07	…			
Central bank	24.54	27.14	31.07	35.69	39.16	…			
(In percent of GDP, unless indicated otherwise)									
External accounts									
Trade balance 1/	-4.1	-3.7	-0.3	2.4	15.7	…		17	20
Exports 1/	186.1	184.0	197.0	202.1	222.5	...		215	220
Imports 1/	190.2	187.7	197.3	199.6	206.8	...		198	200
Gross international reserves (millions of U.S. dollars)	355.6	354.0	479.1	647.8	706.8	…			
Number of tourists (in millions)	2.14	2.11	2.14	2.16	2.11	1.95	Nov-09		
Exchange rate	The euro is the official currency of San Marino								
Social Indicators									
Population, total (2007)	30,580								
Life expectancy (2006)	82.2								
Male	79.4								
Female	85.1								

Sources: Sammarinese authorities; Fitch Ratings; World Bank; and IMF staff estimates.

1/ Based on national account data.

Statement by Arrigo Sadun, Executive Director and Francesco Spadafora, Senior Advisor to Executive Director
February 17, 2010

At the outset, the Sammarinese authorities wish to thank the Fund's mission teams for the high-quality and balanced reports, which are testament to the excellent dialogue and working relationship with the Fund. The authorities have greatly benefited from the conclusions of the FSAP, as well as from the Article IV discussion on policies to mitigate macro-financial vulnerabilities and support growth. They broadly share the Fund's recommendations.

San Marino's economy has not been immune from the global crisis. Growth turned negative in 2008, deteriorated in 2009, and is likely to remain negative (at -1.8 percent) also in 2010. As a consequence, inflation is declining and unemployment is projected to hit 5.5 percent in 2010. Mirroring the sharp deterioration in domestic demand, the trade balance is improving (a surplus of 20 percent of GDP is projected for 2010, up from 17 percent in 2009).

Against this background, the authorities' policy response in the short term focused on addressing the banks' liquidity position, improving financial sector supervision, and supporting the economy through fiscal policy.

Over the medium term, the authorities aim to seize the opportunities arising from a new international environment characterized by greater transparency in economic and financial areas. To this end, their overarching objective is to strengthen San Marino's integration in the global economy and facilitate the transformation of the country's business model through enhanced international cooperation and transparency.

Fiscal Policy

The authorities have adopted several fiscal measures to support the economy in the current downturn, bearing in mind the need to preserve the medium-term sustainability of public finances.

A scheme to subsidize enterprises that are planning to invest in new technologies was introduced in 2009, while unemployment and wage supplementation benefits (*Cassa Integrazione Guadagni*) have been expanded. A more comprehensive reform of social safety nets is planned to be implemented in 2010.

Following the above discretionary measures and the sharp contraction in revenues from the economic slowdown, the fiscal accounts will result in a significant deterioration. The central government's balance is expected to be -4.3 percent of GDP in 2009 (the first deficit since 2002) and -3.5 of GDP in 2010. Owing to prudent fiscal policy over the years, the public sector had accumulated significant bank deposits, equivalent to about 23 percent of GDP as of October 2009.

In order to preserve medium-term fiscal sustainability, the government is actively engaged in reducing current spending. Moreover, a pension reform is being implemented, based on defined-contribution pension funds (second pillar), which should integrate the public pension system. In the medium term, the introduction of co-payments on certain health care services could be taken into consideration.

Financial Sector

The banking sector is a traditional source of growth for the country and its capitalization is high by international standards. Following an Italian tax amnesty (effective September 2009) to stimulate individuals and businesses to repatriate their off-shore assets, the banking sector has been coping with sizable deposit outflows.

The Central Bank of San Marino (CBSM) took several initiatives, some in close cooperation with the Italian authorities, to effectively tackle short-term liquidity developments and boost its lender-of-last-resort capacity. The authorities' pro-active stance to address liquidity pressures have helped the orderly unwinding of banks' positions, and all the banks have been able to meet depositor requests.

In particular, to enhance the CBSM's ability to monitor liquidity, banks were asked to report their liquidity position frequently (eventually on a daily basis), and to disclose the maturity structure of their balance sheets. In mid-November 2009, the CBSM established a voluntary and incentive-based facility whereby banks with excess liquidity could deposit funds with the central bank. At the end of November 2009, a Decree-Law allowed the government to guarantee any foreign borrowing by the CBSM to help secure credit lines from domestic or foreign banks to be used for temporary liquidity assistance to financial institutions. In early December 2009, another Decree-Law imposed on banks a mandatory 8 percent deposit requirement with the CBSM.

In the context of the renegotiation of the 2000 Monetary Cooperation agreement with the European Community, in November 2009 San Marino also started negotiations on the possibility for its banks to gain access to the Eurosystem liquidity.

The CBSM also provided liquidity assistance to the largest bank (*Cassa di Risparmio della Repubblica di San Marino*-CRSM), following the financial difficulties that started in June 2009 as a result of the exposure to Delta, its Italian subsidiary. A recapitalization plan unveiled in mid-January 2010 is being implemented to strengthen CRSM's financial position. The plan revolves around two measures: an overall capital injection, with contributions from the government, the local banking sector, Sammarinese private investors, and the current shareholders; and the issuance of medium-term bonds. The CRSM indicated that the plan would bring the bank's CAR above 11 percent, which will be the minimum requirement by 2013.

The authorities have stated their commitment to strengthening the enforcement capacity of financial sector supervision. As noted in the FSSA report, in the recent period commendable progress was made by the CBSM in this area. Prior to 2005, financial regulation in San Marino was limited, with insufficient legislative regulation consistent with the Basel Committee Core Principles for Effective Banking Supervision. Over the past four years, the CBSM has been the main driver toward developing proper prudential and supervisory frameworks in line with international standards.

The Government recognizes the important role carried out by the CBSM, in particular with regard to on-site supervision. Since its establishment, it has ensured increasing resources to conduct efficient and timely inspections. To this end, the CBSM's staff has been increased by over 40 percent since 2004.

The authorities have stated their commitment to strengthening the anti-money laundering and combating the financing of terrorism (AML/CFT) regime. Following the 2007 MONEYVAL mutual evaluation, the authorities acted swiftly and steadily to fix the shortcomings and fill the gaps of the AML/CFT regime. Since the adoption of the MONEYVAL Mutual Evaluation Report in 2008, San Marino has achieved considerable progress in bringing its legal and institutional framework in line with the FATF recommendations. As a result of this progress, MONEYVAL lifted the compliance enhancing procedure in September 2009. An on-site visit of San Marino is planned in September 2010, as part of MONEYVAL's fourth round of mutual evaluations.

Improving the Business Environment

As stated in the introduction, the developments at the international level toward an environment characterized by greater transparency in economic and financial areas are seen by the authorities as new opportunities to be seized in order to strengthen San Marino's international integration and cooperation, and to facilitate the transformation of the country's business model.

To this end, between April and September 2009, San Marino signed 12 OECD compliant bilateral agreements on exchange of information on tax matters, and eight additional bilateral agreements were signed as of mid-January 2010[1]. As a result of this effort, the country joined the OECD "White List".

In the context of a renegotiation of the 2000 Monetary Cooperation agreement with the European Community, San Marino is working on the European Commission's request to adopt over time all relevant EU legislation relating to the activity and supervision of financial institutions, AML/CFT, and statistical reporting requirements. The ultimate objective is to create a level playing field between San Marino and the European Community for its financial sector.

In this regard, it should be noted that, while the financial sector is a traditional source of high growth, making up about 20 percent of GDP and 10 percent of the government's total revenues, industry has the largest contribution to GDP (38 percent), and another major contribution (nearly 20 percent) also comes from tourism and commercial. As correctly noted by staff, these features of the economy of San Marino should help in addressing current challenges.

The government has taken important steps toward product market liberalization and streamlining. The business licensing system has been reformed in 2009, with the aim of reducing political discretion in awarding licenses, expediting bureaucratic procedures, and reducing barriers to entry. Measures have also been taken to discourage the establishment of anonymous companies and to increase transparency. However, the authorities consider that restrictions on ownership and entry barriers should remain in those sectors (i.e., real estate, telecommunication, and car rental), which are particularly vulnerable to money-laundering activities.

The authorities are planning several reforms to strengthen the labor market, most notably through active labor market policies to assist unemployed workers and enhance employability. Additional benefits may come from a double-taxation agreement with Italy that is set to be signed in 2010.

The authorities have a more cautious approach than staff on increasing labor market liberalization. This is due to the extremely limited size of the territory and to the upward trend in unemployment as a result of the current economic crisis. The number of cross-border workers at the end of 2009 amounted to about 41 percent of the total employees in the private sector.

The Government is currently working on a draft law to regulate residence permits to better respond to the growing demand for high-qualified workers from abroad. At the same time, it is actively promoting local expertise through specialized training of Sammarinese workers and students.

With regard to public administration, an ambitious plan has been launched to increase flexibility and productivity, including through higher education requirements for new employees and more transparency in the hiring process. Finally, a number of measures are planned to reform state-owned enterprises. In this context, the authorities are considering adjusting tariffs in the utility sector more in line with market prices, and moving to a more cost effective procurement system.

San Marino has close links with Italy, which accounts for 90 percent of trade in the context of a customs union. The authorities have given new impetus to strengthening cooperation with Italy, most notably through the signature of Economic and Financial Cooperation agreements in 2009. The latter outlines the conditions for San Marino banks to be granted direct access to the payment systems of the EU, and both will also help reposition the country in the new international environment of greater transparency.