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REPUBLIC OF SAN MARINO

2012 ARTICLE IV CONSULTATION

May 2012

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 2012 Article IV consultation with San Marino, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 2, 2012, 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 April 11, 2012. 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.
- **Informational Annex** prepared bt the IMF.
- **Public Information Notice** (PIN)summarizing the views of the Executive Board as expressed during its April 27, 2012 discussion of the staff report that concluded the ArticleIV consultation.
- **Statement by the Executive Director** for San Marino.

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

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REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

April 11, 2012

KEY ISSUES

Context: The economy is struggling to recover from a long recession, while undergoing a fundamental adjustment of the country's business model. Risks to the outlook are mostly on the downside, as San Marino is facing serious economic and financial headwinds, not least because of the permanent shock to output from the loss of the tax haven business. Normalizing economic and financial relations with Italy will be vital to facilitate a successful repositioning of the economy.

Financial Sector: The banking sector is shrinking, while facing rising vulnerabilities, due to marked declines in liquidity, asset quality and profitability. Consequently, capital buffers have eroded, necessitating recapitalization of the largest bank.

Fiscal Policy: A sizeable permanent decline in tax revenues, mostly related to the downsizing of the financial sector, has weakened the fiscal position. Financing the fiscal deficit is becoming increasingly challenging. A comprehensive medium-term fiscal consolidation is needed to ensure debt sustainability.

Structural Issues: Restoring competitiveness and developing a platform for sustainable growth is a long-term challenge. Recent reform efforts to reduce structural impediments in product and labor markets are an important step, but more needs to be done in these areas to further enhance the economy's flexibility.

Approved By
Aasim Husain and Thomas Dorsey

The 2012 Article IV discussions were held in San Marino during February 21–March 2, 2012. The staff comprised Mr. Epstein (Head), Mr. Jeasakul (both EUR), Ms. Mowatt (SEC), and Mr. Pratt (MCM consultant). Mr. Jiménez de Lucio (STA) also conducted a parallel technical assistance mission. The mission met with Finance Minister Valentini and Central Bank President Clarizia, other cabinet members, senior officials, and private sector representatives.

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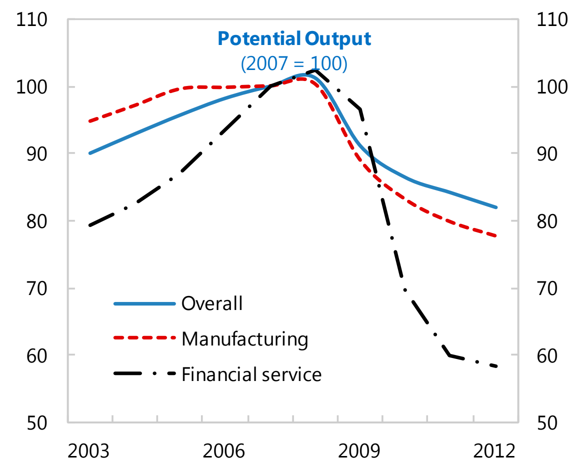
MACROECONOMIC SETTING

A. Fundamental Challenges

1. **The Sammarinese economy is undergoing a fundamental adjustment.** For years, the economy benefited from its tax haven status. Banks were able to attract substantial deposits from Italy and elsewhere, helping to boost financial system assets to around 950 percent of GDP in the pre-crisis period. However, the global financial crisis has had a far-reaching impact on the economy. In addition to facing sharply reduced demand for its exports, San Marino has been forced to embrace greater transparency and rethink its bank secrecy status. In particular, Italy's 2009–10 tax amnesty resulted in significant outflows of bank deposits from San Marino, and Italy's inclusion of San Marino on a 'blacklist' of tax haven countries in 2010 further strained relations between the two countries and hampered Sammarinese growth prospects.

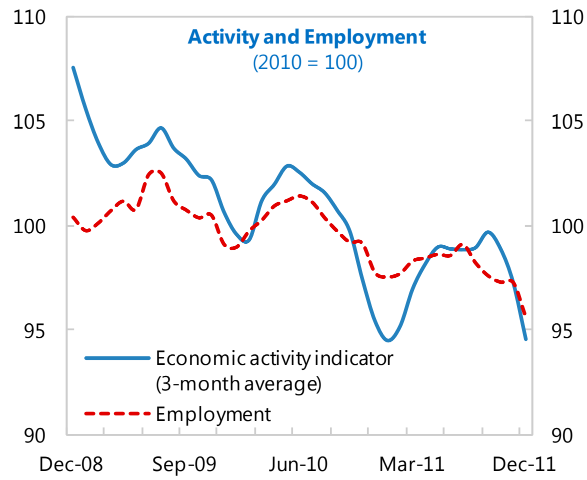
2. **A protracted recession has led to a permanent loss of output (Figure 1).** Between 2008 and 2011, the economy contracted by about 22 percent, of which around three-quarters is estimated to be permanent, mainly due to a significant compression of financial institutions' balance sheets as well as a sharp decline in the manufacturing base. Banks have witnessed large-scale non-resident deposit outflows, while nonbank financial companies have lost almost all their fiduciary business. At the same time, manufacturing activity fell by 30 percent, of which two-thirds could be permanent as a number of Sammarinese firms that have relocated to Italy may not return even after relations between the two countries normalize.



Sources: UPECEDS; and IMF staff calculations.

3. **The authorities have recognized the need to adjust their economic model and explore new sources of growth.** There has been broad support across the political spectrum for efforts to enhance transparency and comply with international standards, which are viewed as critical for normalizing relations with Italy. In particular, the authorities have amended laws and regulations and stepped up enforcement in response to critical reports by MONEYVAL on money laundering and the OECD on tax transparency. While developing new sources of growth is a key long-term goal, both the authorities and the private sector are pinning their hopes on a speedy removal from the Italian 'blacklist' to help turn the economy around.

B. Recent Developments



Sources: UPECEDS; and IMF staff calculations.

4. The economy remains very weak. After four years of GDP contraction, largely manifested in a sharp fall in exports and investment, the economy remains fragile, with recent activity indicators pointing to limited signs of recovery. Rising unemployment, stagnant wage growth, and lower confidence have all contributed to falling private consumption and low inflation. Meanwhile, the financial sector is vulnerable, due to a sharp deterioration in liquidity and profitability, the unresolved recapitalization of the largest bank, Cassa di Risparmio della Repubblica di San Marino (CRSM), and recent difficulties at some smaller banks.

5. As of end-2011, activities in most sectors are well below their pre-crisis levels, with the exception of tourism (Figure 2). The manufacturing sector, which is tightly integrated with Italy's production chains, now faces weak demand prospects owing to the euro area slowdown. The financial sector is also adjusting, with the system continuing to endure a compression of balance sheets driven by a steady decline in deposits. Moreover, construction activity remains markedly below pre-crisis level, while companies in the commercial and non-financial services sectors continue to shut down businesses. In contrast, tourism is the only sector where growth has been robust, albeit its share of GDP is small.

6. Employment continues to fall, with rising unemployment and increasing claims on the benefits provided by the wage-supplemental system (Figure 3). Following strong employment growth during the pre-crisis period, employment has been on the decline over the past three years. Meanwhile, the unemployment rate has trended higher from a low of around 2½ percent in mid-2008 to almost 7 percent recently. Claims on benefits under the wage-supplemental system remain elevated, mitigating a much higher unemployment rate.

C. Outlook and Risks

7. The recession is expected to linger through 2012, with modest recovery over the medium term, in line with output developments in Italy. Under the baseline scenario, staff projects that real GDP will decline by 2 percent this year, mainly due to weakening demand for exports and structural difficulties in the financial sector, which is struggling to adopt a new business model. Moreover, investment activity and durable consumption will likely be constrained by the continued decline in private sector credit, as banks face funding outflows and rising nonperforming loans (NPLs). Given the subdued economic outlook for Italy, which accounts for 90 percent of Sammarinese exports (Figure 4), staff projects a very gradual recovery in 2013 with growth hovering around 1½ percent over the medium term.

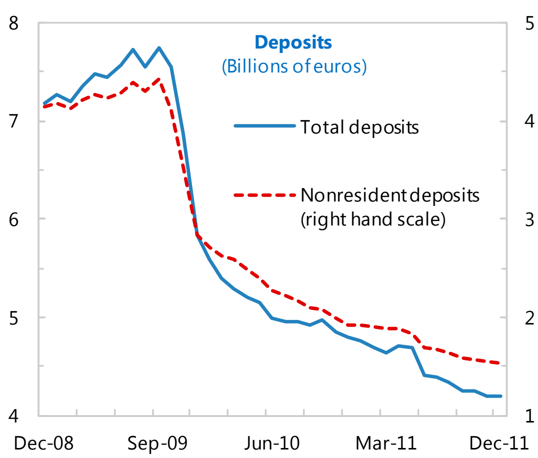
8. Risks to the outlook are mostly on the downside. San Marino is facing serious economic and financial headwinds, not least because of the permanent shock to output from the loss of the tax haven business. Key downside risks to the baseline outlook include a deeper than expected recession in Italy and rising strain in the financial sector. On the upside, normalizing relations with Italy could provide a boost to confidence. In particular, the ratification of the double taxation treaty with Italy, which is a precondition for the implementation of key economic and financial cooperation agreements between the two countries, could promote cross-border activity.

9. Uncertainty about Italy's economic and financial situation underscores the potential for a protracted recession and heightened stress in the financial sector. Besides the trade channel, the banking system exposure to Italy is substantial, at around €1.4 billion, or close to 100 percent of San Marino's GDP. Under an adverse scenario, which envisages worsening developments of the euro area debt crisis, and larger than expected output contraction in Italy (3.5 percent vs. 1.9 percent under the baseline), real GDP would decline by around 4 percent in 2012 (see Annex I for a Risk Assessment Matrix).

FINANCIAL SECTOR ISSUES

A. Recent Developments and Vulnerabilities

10. The banking sector has seen a significant compression of balance sheets (Figure 5). Following the tax amnesty, banks lost about 30 percent of their deposits. Unlike previous episodes in which the funding outflows were later reversed, Italian customers are not returning, which may reflect a realization that San Marino cannot sustain the bank secrecy advantage that underpinned its banking system for so long. In fact, bank balance sheets continue to contract, primarily driven by a steady decline in deposits (mostly



Sources: CBSM; IMF, International Financial Statistics; and IMF staff calculations and estimates.

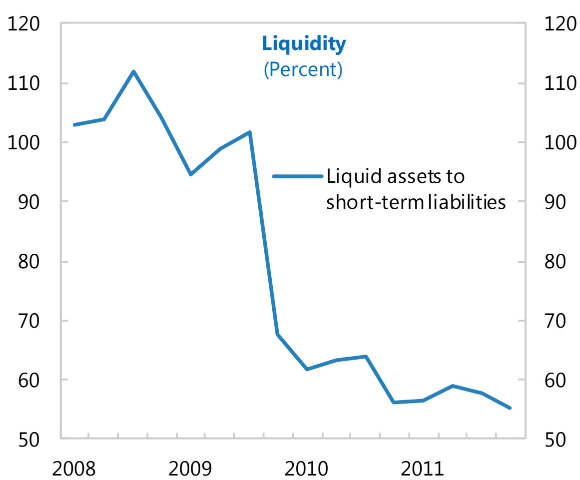
Financial System Overview

	Dec-08	Dec-09	Dec-10	Jun-11
Number of Financial Institutions				
Banks	12	12	12	12
Financial companies	53	48	40	35
Assets and Liabilities (millions of euros)				
Banks' assets	11,536	9,447	8,091	7,259
Banks' funding	9,536	7,510	6,357	5,845
Financial companies' assets under fiduciary administration	3,460	1,921	1,061	793

Sources: CBSM; and IMF staff calculations.

nonresident). More recently, five banks are being merged or closed, in part through actions of the central bank (CBSM) in response to irregularities and weak financial position, with the number of banks expected to decline from twelve to seven this year. Separately, as of end-2011, there was only one Sammarinese bank that is part of a foreign banking group.[1]

11. Banks are increasingly vulnerable to liquidity risks (Figure 6). In the past, Sammarinese banks held a substantial amount of liquid assets, mostly in the form of securities issued by Italian banks, as the amount of deposits they could raise far exceeded the amount of loans they could extend locally. However, the large deposit outflow triggered by the tax amnesty caused liquidity to deteriorate significantly, with the ratio of liquid assets to short-term liabilities falling sharply.



Sources: IMF, International Financial Statistics; and IMF staff calculations.

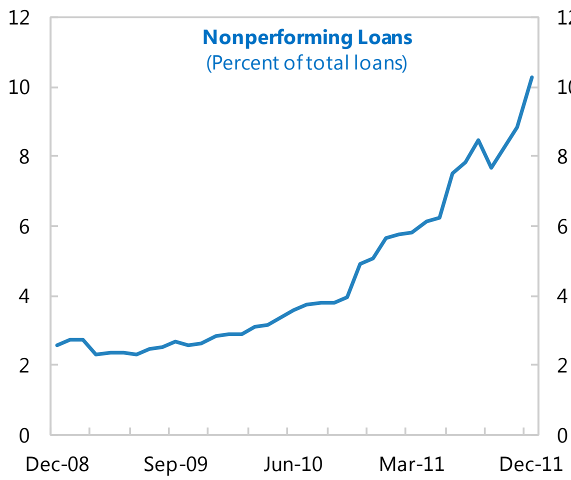
12. San Marino lacks effective mechanisms to manage significant liquidity pressure. Notwithstanding the progress made by the CBSM to ensure adequate liquidity in the banking system, including a facility to share liquidity[2] and monitoring banks' liquidity position on a weekly basis, the CBSM does not have the capacity to act as a lender of last resort due to its inability to create money. Meanwhile, Sammarinese banks do not have access to the ECB window, leaving liquidity pressures very difficult to manage.[3] A deposit insurance scheme has recently been established by the CBSM, with coverage of €50,000 per account. CBSM's attempt to secure contingent credit lines with other central banks has not been successful.

13. Banks' profitability and capital weakened significantly, mainly due to steadily rising NPLs (Figure 6). In the first half of 2011, six banks registered losses totaling €55 million (more than half attributable to CRSM). NPLs, mainly concentrated among corporates (e.g., the construction sector), have doubled over the past year, to almost 10½ percent of total loans, and are expected to continue to increase on the back of the very weak economic outlook. As sizeable provisions for potential loan losses are needed, banks' profits have been squeezed and banks' capital has eroded.

[1] While there are no legal barriers, the lack of a formal cooperation agreement on financial matters with Italy at present likely discourages foreign banks from acquiring Sammarinese banks.

[2] The CBSM imposes reserve requirements and accepts voluntary deposits from banks, and could use such liquidity resources to assist banks.

[3] See also "San Marino: Options for Managing Systemic Liquidity Risk" (IMF, Country Report No. 10/66).



Sources: CBSM; and IMF staff calculations.

14. The recapitalization of CRSM is a key priority, which requires a balance sheet restructuring and a sustainable business model. CRSM has made substantial losses in the past three years, largely as a result of its decade-long involvement with the Italian Delta group. The losses from the resolution of Delta's collapse will leave CRSM needing more capital and with a balance sheet dominated by Delta-related assets. The government is contemplating participating in a proposed €150 million recapitalization plan (see Box 1).

15. Stress tests of Sammarinese banks reveal that the banking system is highly vulnerable to credit and liquidity risks, with potential bank recapitalization needs being substantial. Illustrative stress tests conducted by staff based on bank-level data (as of June 2011) suggest that the banking system is vulnerable to three key risks: (i) rising NPLs on the back of continued economic weakness, (ii) losses related to impaired assets associated with European peripheral countries, and (iii) potential funding outflows in the face of banks' relatively weak liquidity position. Even under a reasonably benign scenario in which, for example, NPLs increase only slightly from present levels, the estimated bank recapitalization needs is sizable (over 10 percent of GDP), mostly attributable to CRSM. Under an adverse scenario, where external conditions significantly deteriorate, system-wide recapitalization needs could be more than twice as high.

B. Structural Issues for the Financial Sector

16. Further progress has been made on meeting the 2009 FSAP recommendations. Over the past year, action has been taken to clarify and strengthen the powers of the CBSM to cooperate with foreign supervisors and enable the latter to undertake onsite supervisions of subsidiaries of banks for whose consolidated supervision they would be responsible. In addition, new regulations on financial companies and tough enforcement action are now in line with the FSAP recommendations. The authorities are committed to meeting EU Directives on bank supervision as a consequence of signing the monetary agreement with the EU in March 2012. However, further action is still outstanding on some of the FSAP recommendations, including with respect to enhancing CBSM and Financial Intelligence Agency (FIA) resources and inter-agency cooperation (see Annex II).

17. The authorities' efforts to enhance transparency have been recognized by OECD and MONEYVAL. The authorities in the past few years have introduced new

Box 1. CRSM and the Recapitalization Plan

The resolution of Delta is almost complete and has left CRSM in need of recapitalization and with a balance sheet dominated by Delta-related assets. As San Marino's largest bank, with 35 percent of the country's deposits, CRSM became involved with the Italian Delta group some ten years ago, through an equity stake, loans and other complex arrangements involving third parties. The Italian authorities placed the Delta group under special administration in 2009, initially because of AML irregularities. Since then, special Commissioners have been winding down the Delta group. Agreement has been reached with most participants but final resolution awaits a decision on an appeal by certain creditors. The resolution, which involves partial repayment to creditors and a substantial reduction in Delta's equity, will result in considerable losses to CRSM, for which CRSM has been preparing by making provisions. The final effect of the resolution on CRSM is not clear and has been subject to different estimates. However, it is clear that the bank will need a capital injection and CRSM has announced a €150 million recapitalization plan.

The government is considering participating in the recapitalization, but the plan has not been finalized. CRSM's recapitalization plan seeks €20 million from its existing shareholders (Foundations), €60 million from the government, and €70 million in subordinated debt to be held by its customers. The bank has indicated that it would wish to make a subordinated debt offer to its retail customers. However, such an offer would not normally be regarded as appropriate for retail customers, even with full disclosure of the risks, and hence should be geared toward institutional investors.

Any government participation in the recapitalization plan should be subject to clear and strict conditionality. First, the existing shareholders should subscribe new capital at the level indicated. Second, CRSM should submit a sustainable business plan which focuses on its traditional business within San Marino and the surrounding areas. The business plan should also aim to reduce the size of the balance sheet and hence the systemic risk posed by the bank. Third, CRSM should prepare a contingency plan against additional losses. Moreover, as supervisor, the CBSM should insist that CRSM embarks on a credible plan to unwind its exposure to Delta-related assets, so that it meets the prudential requirements on concentration risk.

regulations that improve economic and financial transparency. The supplementary report by OECD's Global Forum on Transparency and Exchange of Information published in October 2011 (under Phase One evaluation) indicated that San Marino has put in place all necessary legal and regulatory frameworks that were pointed out as shortcomings in the previous report (January 2011), with a recommendation that San Marino can be now reviewed under Phase Two (effective implementation of the frameworks in place). The MONEYVAL AML/CFT mutual evaluation report of September 2011 also pointed to significant progress, noting however that deficiencies remain in some areas, such as AML/CFT supervision and customer due diligence.[4]

18. **New regulations and normalization of relations with Italy are necessary but not sufficient conditions for the development of the financial sector.** The authorities

[4] AML/CFT supervisory resources continue to be constrained and frequently diverted to meet the requests from judicial authorities. Moreover, no other regulatory or legal changes have yet been made in response to the September 2011 MONEYVAL recommendations on customer due diligence.

understand well that the former business model that led to a rapid expansion of the financial sector on the basis of bank secrecy and weak regulations is no longer viable. Regulations at international standards, the opening of channels of cooperation, and action to respond to recommendations of MONEYVAL with respect to AML/CFT and the OECD in respect of transparency on tax matters will inhibit a return to the old business model. The building of a base of effectively enforced regulations and the normalization of relations with Italy are necessary conditions for the financial sector to survive. However, they are not sufficient. Given that the previous business model is untenable, the financial sector needs to find a new, alternative, more sustainable competitive edge.[5]

C. Authorities' Views

19. The authorities agreed with staff's assessment on the financial sector vulnerabilities. In particular, they shared the concern about rising liquidity pressures, further increasing NPLs and the weak outlook for bank profits. The authorities appreciated staff's bank stress tests results, and are considering completing their own stress tests. The authorities also shared the concern about the limited tools available to the CBSM to provide adequate liquidity support to the banking system.

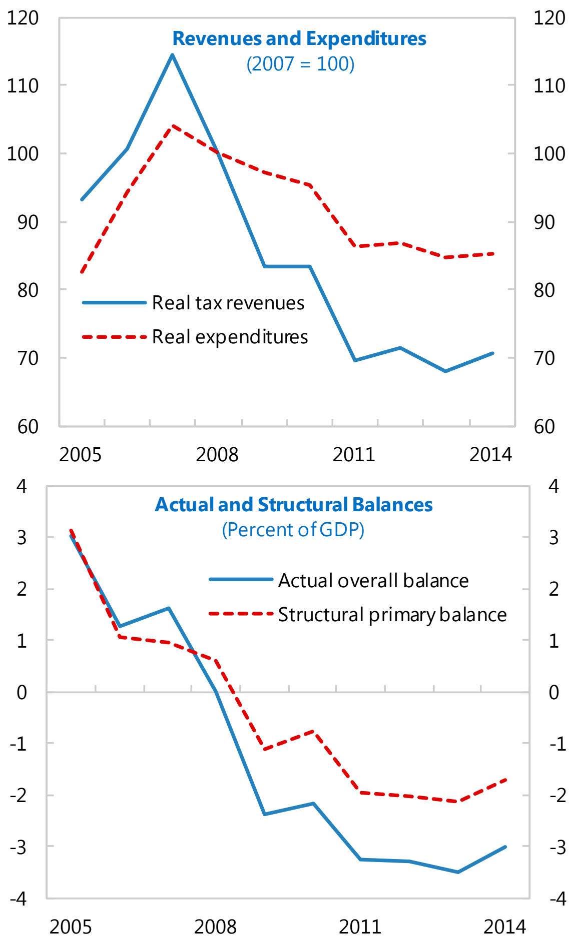
20. The authorities are considering the appropriate conditionality for government participation in the recapitalization of CRSM, but have emphasized that it is for the bank's management to determine the future path**.** The authorities have accepted the need to limit systemic risks from CRSM and to push the bank towards developing a prudent business plan. They pointed out that there is no completely objective basis for determining the likely scale of losses on Delta and hence the scale of write-downs and the level of capital that may be required. They agreed, however, on the need for a contingency plan.

21. The authorities consider that the private sector should take the lead in developing a new business model. The authorities pointed to the action they have taken in developing new laws and regulations as a platform for the financial sector and in taking steps towards normalizing relations with Italy. They agreed that it is up to the private sector to develop a new business model and invest in the appropriate training and capacity building.

FISCAL POLICY ISSUES

A. Fiscal Policy Developments

22. **The fiscal position has weakened, mainly due to a sizeable decline in tax revenues (Figure 7).** Tax receipts, in real terms, are estimated to have fallen by more than 30 percent over the past four years, largely due to the recession and lower revenues from the financial sector. Over the same period, expenditures fell by half as much. Consequently, fiscal surpluses have turned into deficits. Staff projects a fiscal deficit of close to 3¼ percent of GDP this year, primarily on account of lower revenue projections. In addition, the structural deficit has been widening in recent years and is expected to remain at about 2 percent of GDP on average over the medium term, pointing to sustained deterioration of the fiscal position under current policies.



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations and estimates.

23. **Financing the fiscal deficit is becoming increasingly challenging.** In 2010–11, the government financed its deficits mainly by drawing down its deposits at the central bank, currently valued at around €150 million (11 percent of GDP). However, over this period, the government has also supported the banking system (principally CRSM) with loan guarantees currently equivalent to €90 million (6 percent of GDP), effectively constraining any additional drawdown on deposits.[6] Moreover, the government has never issued debt securities on capital markets. Under the baseline scenario, gross government financing requirements in 2012 are estimated at around 15 percent of GDP (if bank recapitalization is included), but could rise to 29 percent of GDP under an adverse scenario.

24. **Government debt is expected to increase moderately in 2012.** Government

[5] For example, there is scope to develop small-scale specialist asset management services. See also "The Development of a New Business Model for San Marino's Financial Sector" (IMF, Country Report No. 11/79).

[6] By Sammarinese law, the level of government deposits must be at least €45 million. Other public entities, including the social security administration and public enterprises, hold together additional deposits of €120 million at the CBSM.

debt, at 18 percent of GDP, is primarily composed of net accounts payable, amounting to about €215 million (15 percent of GDP), which were recently classified as debt to properly reflect the government's liabilities (see Annex III). Under the assumption that the government would not draw further on its deposits, government debt is expected to rise to 21 percent of GDP in 2012.

B. Fiscal Consolidation Strategy

25. The government has taken initial steps to reduce the fiscal deficit. In its latest budget, the government extended the temporary surtax on income tax paid in the previous year, introduced a special tax on property, and imposed a minimum corporate income tax applied to all companies. Together, these measures are expected to yield additional revenues of about 1 percent of GDP this year. Expenditure is projected to remain constant in real terms in 2012, though expected to rise slightly as a percent of GDP, while the public sector wage bill will be contained by a freeze on nominal wages (in place since 2011).

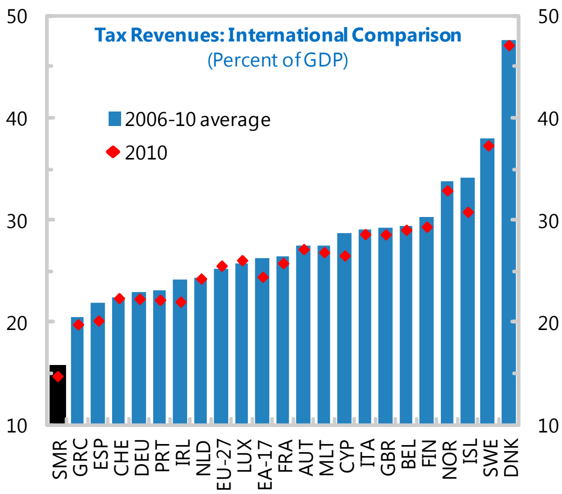
26. The authorities are also in the process of implementing structural fiscal reforms. The government plans to introduce a broader tax reform, aimed at improving the equity and efficiency of the income tax system. The current system is rather complex for a small country, and the tax reform should provide a welcome simplification by unifying tax rates and cutting some tax allowances and credits (see Annex IV). Public administration reforms already underway encompass an organizational restructuring and improved control of public finances, including a reduction in posts due to outsourcing of activities and natural attrition. Staff's estimates suggest that the proposed tax and public administration reforms together would yield savings equal to about 1 percent of GDP by 2017.[7] In addition, the parliament passed two pension reform laws in 2011. The first law, aimed at enhancing the sustainability of the first pillar pension system, introduced measures such as higher contribution rates and lower replacement rates. The second law established a second pillar system, with compulsory participation and shared contributions from employers and employees. Finally, the public utilities company, in an effort to reduce its operating losses, has been increasingly active in the Italian energy exchange. The authorities understand the need to closely monitor these activities so as to minimize the risks to public finances.

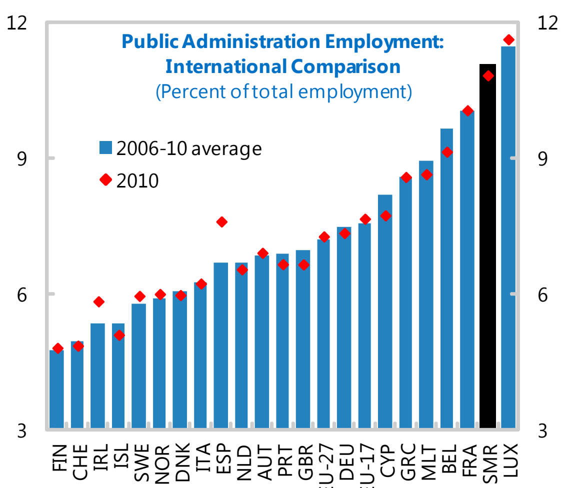
27. A more ambitious medium-term consolidation strategy is needed. Given that revenues are likely to be permanently depressed by the financial sector downsizing, contingent liabilities from the financial sector are likely very high, and the government lacks access to a diversified investor base, the government needs to embark on more ambitious durable reforms to secure an effective medium-term consolidation strategy and debt sustainability. On current policies, government debt is projected to rise from 18 percent of GDP today to 28 percent of GDP by 2017. However, in the event that the

[7] The government is also examining the possibility of a value-added tax (VAT), to replace the current tax on imports.

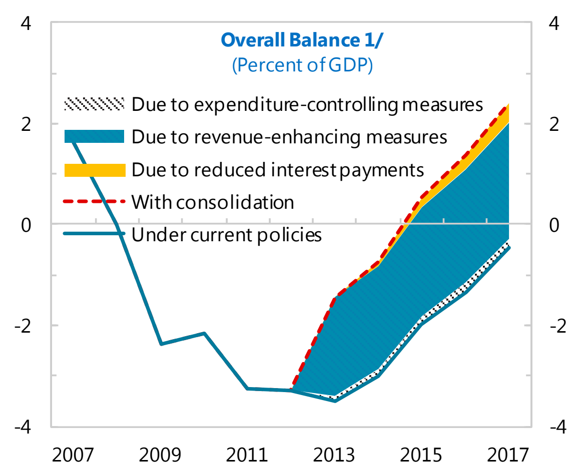
government needs to issue debt for bank recapitalization, debt could reach close to 40 percent of GDP, while spillover risks from rising sovereign-bank linkages could be significant.

28. Staff recommended permanent consolidation measures of about 2½ percent of GDP, primarily on the revenue side, starting in 2013 when the economy is expected to emerge from recession. Given that tax revenues, as a share of GDP, are very low by international standards, the consolidation plan should focus on increasing tax revenues, primarily through reducing income tax allowances and credits beyond income tax allowances and credits beyond current plans and broadening the application of indirect taxes. For example, the authorities should aim to increase the effective tax rate on personal income, currently at a low 4½ percent (or about one third the average EU level). Moreover, expanding the tax base could include extending and possibly raising the rate of the current tax on domestically produced services and the extension of the special tax on property. Staff also sees scope to introduce some expenditure-control measures, for example, by further containing the growth in the public sector wage bill. Altogether, these permanent measures could yield savings of 2½ percent of GDP and help lower government debt to around 16 percent of GDP over the medium term (see Annex IV).





Sources: Eurostat; Sammarinese authorities; UPECEDS; and IMF staff calculations and estimates.



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculation, estimates and projections.
1/ Based on the consolidation plan recommended by staff.

C. Authorities' Views

29. The authorities broadly shared the staff's assessment of the fiscal position. They concurred with staff that various options for financing the deficit need to be examined as a matter of urgency, and noted that they had made initial contact with an investment bank and another ratings agency (in addition to Fitch) to explore access to international capital markets.

30. The authorities also agreed on the need for further consolidation. They remain cognizant of the need for additional fiscal tightening and are moving ahead with a number of reforms to achieve savings. The government welcomed staff's recommendations and is examining specific measures with the social partners.

STRUCTURAL AND OTHER POLICY ISSUES

A. Product and Labor Markets

31. Notwithstanding recent efforts to reduce rigidities in product markets, further reforms are needed to enhance the economy's competitiveness. The government has taken steps toward liberalizing product markets, but some bureaucratic processes are cumbersome and barriers to entry in certain non-tradable sectors remain. For example, while there are no outright restrictions on foreign ownership of property (albeit foreign ownership of certain commercial activity is restricted), an authorization is required. Moreover, complicated regulations can significantly deter foreign investors. Currently, the government is considering a reform that further streamlines the business licensing process.

32. The centralized employment system has been relaxed, but various labor market distortions remain and need to be further eased. Although a recent government decree enables firms to freely conduct a search for candidates, obstacles to hiring highly skilled nonresident workers linger. In addition, regulations related to cutting redundancy and the role the public sector plays as a major employer hinder market-driven private sector employment. Indeed, labor market practices largely operate under a 1961 law, which renders the regulatory framework outdated.

33. Developing a basis for sustainable growth is a long-term challenge. Since 2005, San Marino has been losing its competitive position vis-à-vis Italy, with increasing relative unit labor costs (Figure 8).[8] The severe recession has also led to a significant decline in productivity on the back of a sharp output contraction, most of which is permanent. Furthermore, the future of both financial services and manufacturing is highly uncertain, given that the financial sector needs to find a new business model and the manufacturing sector faces weak demand prospects and stiffer competition (Box 2).

[8] See also "Assessing San Marino's Competitiveness" (IMF, Country Report No. 11/79).

Box 2. In Pursuit of a New Growth Model

San Marino faces dim growth prospects. San Marino's potential GDP is estimated to have declined in recent years by 16 percent, largely due to the significant compression of the financial sector and the sharp reduction in the manufacturing base. Moreover, the financial sector will likely continue to contract if new businesses that do not rely on bank secrecy are not found. Meanwhile, the manufacturing sector, which has lost its competitive position in recent years, faces growing uncertainty given weak demand prospects from Italy and stiffer long-term competition from countries with lower labor costs. As these two sectors account for slightly more than half of San Marino's GDP, securing sustainable long-term growth in a new environment of enhanced transparency is very challenging.

Limited action has been taken in the financial sector towards adoption of a new business model, as no new products and services have been identified and developed, despite regulatory reforms. Indeed, most banks are focusing on providing local and regional traditional banking services. One or two institutions are developing niche products to sell to professional Italian (and other foreign) investors. However, the financial sector has not collectively determined on a niche business that might constitute a new Sammarinese brand. Instead, most of the remaining seven banks are aiming to offer traditional banking services to retail and corporate customers in San Marino and the surrounding regions. However, most agree that the market is unlikely to sustain more than a few Sammarinese banks offering such services (which would be in competition with existing Italian regional banks). Unless action is taken to find a unique competitive edge, the prospect is for further decline in the number and size of financial institutions. This would mitigate contingent liability risks to the government but would also reduce tax revenues and employment opportunities.

Further structural reforms are essential for achieving sustainable growth. Given diminished growth prospects, greater attention is needed to exploring avenues for sustainable growth. This may involve promoting tourism and other selective economic sectors where San Marino may have an advantage. Moreover, given lingering structural impediments to growth, additional reforms are necessary to enable product and labor markets to function more flexibly to meet new business needs. In particular, measures to (i) promote foreign investment that improves entrepreneurial know-how, and (ii) reduce firms' obstacles in hiring highly skilled nonresident workers should be undertaken as a priority to facilitate the economy's adjustment to a new growth model.

B. Statistical System

34. The availability of macroeconomic statistics is limited. Notwithstanding important progress on compilation and dissemination of monetary and financial sector data, national account (NA) statistics and fiscal data do not have the frequency and detail required by international standards and are only available with a considerable lag. In addition, the authorities do not prepare standard macroeconomic projections. A September 2011 STA mission provided technical assistance (TA) on NA statistics, but further work is needed to fully revise the NA data (see Annex V). A recent STA mission on fiscal statistics helped identify and clarify anomalies concerning government accounts receivable and payable. Limited staff is a major obstacle to improved macroeconomic statistics.

C. Authorities Views

35. **The authorities welcomed the staff's assessment of recent labor and product market reforms,** which they see as a signal that they are moving in the right direction. At the same time, they noted the need to balance growth concerns with social ones and pointed out that labor market rigidities in San Marino are less severe than in other European countries.

36. **On the growth model, the authorities' aim is to promote a diversified economy** while exploring niche sectors where San Marino could have a competitive advantage. They highlighted the planned Science and Technology Park, a joint project with Italy, as an example of this. However, they stressed that removal from the Italian blacklist is key to reviving manufacturing activity.

37. **On macroeconomic statistics, the authorities stated that they are committed to devoting additional human capital** to this area, and expressed interest in continued Fund TA.

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38. **The economic recession continues, while uncertainty looms large.** After four years of GDP contraction, primarily driven by external factors and largely manifested in a sharp fall in investment and manufacturing activity, the economy remains weak, with rising unemployment and construction activity well below its pre-crisis levels. Growing uncertainty about the external environment and the future role of the Sammarinese financial sector underscore the potential for a protracted recession and increasing vulnerability of the financial system. In this context, normalizing relations with Italy will be vital to facilitate a sustainable recovery and successful repositioning of the economy.

39. **The financial sector is vulnerable, due to marked declines in liquidity, asset quality and profitability.** The banking system was able to withstand the large deposit outflow during 2009-10, largely because of the previous substantial holdings of, mainly foreign, liquid assets. Since then, banks' balance sheets have continued to decline on the back of steady deposit outflows, contributing to the deterioration of liquidity. As a consequence of the prolonged recession, NPLs have doubled over the past year and bank profits have turned into losses, putting pressure on capital buffers.

40. **The recapitalization of CRSM is a priority, which requires a balance sheet restructuring and a sustainable business model.** CRSM has made substantial losses in recent years. The authorities are rightly insisting that CRSM should raise new capital and restructure its balance sheet. The government should make participation in the recapitalization strictly conditional on the existing shareholders meeting their commitment to add new capital and on the bank adopting a sustainable and sound business plan. Given its systemic risks, CRSM should develop a contingency plan for future losses, ensure its compliance with prudential norms, and build a sustainable business model.

41. The authorities continue to make progress on meeting the FSAP recommendations. Further measures have been taken to strengthen the supervisory functions and independence of the CBSM and lower barriers to international regulatory cooperation. Remaining FSAP recommendations, particularly on CBSM and FIA resources, and inter-agency cooperation should be further considered. Progress on broader transparency initiatives has been recognized by both the OECD and MONEYVAL, and early action should be taken to address remaining recommendations, with particular attention on implementing the regulatory frameworks already in place. Indeed, creating a track record of effective implementation of measures and international cooperation is important to further rebuilding of confidence.

42. The financial sector should adapt to the new domestic and international environment in which it operates. In practice, international pressure and tougher new domestic regulation have already reduced the size of banks' balance sheets. Some in the private sector are looking creatively for niche products to sell on the international market, but most are seeking to provide traditional banking services to San Marino and the surrounding regions. Practical action needs to be taken by the financial sector to identify a competitive advantage, if it exists, and to prepare for a smaller financial sector, if it does not.

43. Measures taken to contain the fiscal deficit are important, but the consolidation strategy needs to be strengthened. In particular, a comprehensive medium-term consolidation plan, largely focused on permanent measures to increase the revenue base, is needed. At the same time, the authorities should develop a plan for deficit financing, including by seeking to issue debt instruments on capital markets. In addition, while the passage of fiscal reforms is a step in the right direction, implementation is key. In particular, the authorities should implement the public administration reform so as to further contain the growth in the public sector wage bill.

44. Restoring competitiveness and developing a sustainable growth model is a long-term challenge. Structural impediments to growth need to be eased. In particular, alleviating rigidities in product and labor markets, including by promoting foreign investment and relaxing obstacles in hiring highly skilled nonresident workers, will be vital to boost competitiveness and create the basis for new viable businesses. It is also imperative that the government and the private sector explore avenues for sustainable growth.

45. Meeting international standards on macroeconomic statistics is vital. The lack of balance of payments (BoP) data hampers a fuller analysis of macroeconomic linkages. The availability of reliable statistics on current economic conditions and transparent government accounts is crucial to designing appropriate economic policies and preparing realistic budgets, and will support San Marino's increased engagement with the international business and financial community. San Marino's ability to absorb TA in this area is inhibited by insufficient personnel. Hence, the authorities need to devote additional resources to meet international standards for national accounts and government finance statistics.

46. It is recommended that the next Article IV consultation with San Marino be held on the standard 12-month cycle.

Table 1. San Marino: Selected Economic and Social Indicators, 2007-13

	2007	2008	2009	2010	2011	Projections 2012	2013
Activity and Prices							
Real GDP (percent change) 1/	3.5	-3.4	-12.8	-5.2	-2.6	-2.0	0.6
Domestic demand	...	-5.8	-9.9	-11.2	...	...	...
Final consumption	...	-0.8	1.2	-7.2	...	...	...
Fixed investment	...	-6.3	-15.0	-20.6	...	...	...
Net exports (contribution to growth)	...	1.1	-5.4	3.5	...	...	...
Exports	...	2.1	-18.8	-11.1	...	...	...
Imports	...	1.7	-18.4	-14.3	...	...	...
Employment (percent change)	3.2	3.5	-0.3	-0.8	-2.2	...	...
Unemployment rate (average; percent)	3.0	3.1	4.5	4.9	5.5	...	...
Inflation rate (average; percent)	2.5	4.1	2.4	2.6	2.0	...	...
Nominal GDP (millions of euros) 1/	1,756	1,732	1,575	1,492	1,472	1,459	1,488
Output gap (percent)	3.2	-1.5	-4.4	-4.4	-4.4	-3.7	-4.1
Public Finances (percent of GDP) 2/							
Revenues	22.7	21.4	21.0	22.7	20.3	21.1	20.3
Expenditure	21.1	21.2	23.3	24.8	23.2	24.3	23.7
Overall balance	1.7	0.2	-2.3	-2.1	-2.9	-3.2	-3.4
Structural primary balance	1.0	0.7	-1.1	-0.7	-1.6	-1.9	-2.0
Government debt	11.8	14.7	18.9	19.1	17.9	21.2	24.2
Loans	3.7	3.8	4.0	3.8	3.3	6.5	9.7
Net account payables	8.1	10.9	14.9	15.3	14.6	14.8	14.5
Government deposits	12.2	15.2	16.3	14.6	10.5	10.6	10.4
Money and Credit							
Deposits (percent change)	...	21.0	9.1	-30.3	-12.3	...	...
Private sector credit (percent change)	19.2	11.5	9.0	-10.3	-13.5	...	...
Net foreign assets (percent of GDP)	40.7	31.6	11.0	28.7	47.9	...	...
Commercial banks	15.6	2.3	-23.8	6.2	30.0	...	...
Central bank	25.1	29.3	34.8	22.5	17.9	...	...
External Accounts (percent of GDP)							
Trade balance of goods 3/	23.2	24.5	24.4	27.9	...	...	...
Exports	214	227	208	196	...	...	...
Imports	191	203	183	168	...	...	...
Gross international reserves (millions of U.S. dollars)	648	707	790	613	342	...	...
Exchange Rate (average)							
Euros per U.S. dollar	0.73	0.68	0.72	0.75	0.72	...	...
Real exchange rate vis-à-vis Italy	100.7	101.4	103.0	104.1	103.4	...	...
Financial Soundness Indicators (percent)							
Regulatory capital to risk-weighted assets 4/ 5/	17.5	16.9	16.9	15.6	15.4	...	...
Nonperforming loans to total loans	0.9	2.6	2.9	5.1	10.2	...	...
Loan loss provision to total loans 5/ 6/	4.3	2.6	3.9	6.3	11.0	...	...
Return on equity (ROE) 5/ 6/	12.1	10.0	-14.4	-24.4	-14.2	...	...
Liquid assets to total assets 7/	37.2	38.3	25.5	17.1	14.9	...	...
Liquid assets to short-term liabilities 7/	96.6	104.3	67.6	56.1	55.1	...	...
Social Indicators							
GDP per capita (2010) 8/	62,596	U.S. dollars					
Ratio of GDP per capital of:							
Italy	1.84						
EU-17	1.65						
Land area	61.2	square km					
Population (December 2011)	32,166	persons					
Population density (December 2011)	525.6	per square km					
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 (2008)	1.2						
Literacy, adult (2008)	81.6						

Sources: IMF, International Financial Statistics; Sammarinese authorities; World Bank; and IMF staff calculations, estimates and projections.

1/ Based on new preliminary expenditure-based national accounts statistics as part of technical assistance by STA, with the revision for 2005-10 expected to be completed by mid-2012.

2/ For the budgetary central government.

3/ Based on national accounts statistics; including goods and services.

4/ The capital adequacy ratios in 2009-11 do not take into account potential CRSM losses incurred on its investment in the Delta group. Following the Delta resolution, CRSM's regulatory capital was estimated at about 11 percent of risk-weighted assets.

5/ As of June 2011.

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

7/ After extraordinary items and taxes, and before provision to fund for general banking risk.

8/ Liquid assets include cash in vault, loans to banks on demand, and securities. Short-term liabilities include due to banks and customers on demand, and repos.

9/ GDP per capita overstates income per Sammarinese worker because Italian commuters account for a quarter of San Marino's labor force.

Table 2. San Marino: Overview of Financial System, 2003-11

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Value added									
Financial services (percent of GDP)	16.4	16.5	16.9	17.7	18.6	18.7	17.6	...	...
Employment									
Total employees in the financial sector	690	734	784	835	910	1,002	1,048	1,080	1,037
Percent of total employment	3.5	3.7	3.8	4.0	4.2	4.5	4.7	4.9	4.8
Banks	431	461	500	559	621	672	704	679	648
Financial companies	...	...	...	168	202	257	250	206	...
Insurance companies	...	0	0	0	0	0	6	8	8
Investment management companies	...	0	0	0	2	3	3	3	4
Others 1/	...	...	...	108	85	70	85	184	...
Enterprise									
Total enterprises in the financial sector	90	97	107	113	116	116	116	114	102
Banks	10	11	12	12	12	12	12	12	11
Of which: foreign-majority owned	6	7	8	7	6	6	6	7	7
Of which: part of foreign banking group	2	2	2	2	2	2	2	2	1
Financial companies	...	39	42	45	53	53	48	40	35
Insurance companies	...	0	0	0	0	0	2	2	2
Investment management companies	...	0	0	0	1	1	2	2	2
Others 1/	...	47	53	56	50	50	52	58	52
Assets (millions of euros) 2/									
Financial system's total assets	6,413	7,155	7,723	13,103	15,172	16,355	12,804	10,507	9,321
Percent of GDP	452	473	490	785	864	944	813	704	633
Banks	6,413	7,155	7,723	8,976	10,415	11,536	9,447	8,091	7,259
Percent of GDP	452	473	490	538	593	666	600	542	493
Share of financial system; in percent	100	100	100	69	69	71	74	77	78
Of which: foreign-majority owned	2,268	2,624	3,154	3,218	3,798	4,414	3,413	2,641	2,487
Share of banking system; in percent	35	37	41	36	36	38	36	33	34
Financial companies	...	...	...	4,127	4,718	4,782	3,255	2,212	1,829
Of which: fiduciary activity	...	...	...	3,144	3,558	3,460	1,921	1,061	793
Insurance companies	...	...	...	...	...	...	78	171	197
Investment management companies 3/	...	...	...	...	38	37	24	33	36
Of which: assets under management	...	...	...	...	38	36	22	31	35
Contribution to fiscal revenues (percent of GDP)									
Financial system 4/	...	...	...	1.8	2.0	2.5	1.9	1.2	0.5
Percent of tax revenues	...	...	...	27.1	31.4	37.5	29.5	15.5	8.2
Income taxes paid by banks	...	1.1	1.6	1.1	1.3	0.5	0.5	0.2	0.0
Percent of tax revenues	...	16.4	22.2	16.4	20.8	7.0	7.7	3.1	0.0
Banking sector 2/									
Total assets (millions of euros)	6,413	7,155	7,723	8,976	10,415	11,536	9,447	8,091	7,259
Percent of GDP	452	473	490	538	593	666	600	542	493
Loans to customers and financial leasing	1,881	2,570	2,941	4,057	4,603	5,257	4,996	4,547	3,948
Loans to banks	580	496	456	840	986	1,251	1,206	1,445	1,470
Bond portfolio and other debt securities	3,263	3,379	3,547	3,185	3,778	3,917	2,312	1,243	1,049
Total deposits (millions of euros)	2,300	2,693	3,747	5,031	6,225	7,183	6,213	4,969	4,605
Percent of GDP	162	178	238	302	354	415	395	333	313
Of which: nonresident deposits	1,244	1,452	2,046	2,815	3,567	4,146	3,021	1,999	1,777
Percent of total deposits	54.1	53.9	54.6	55.9	57.3	57.7	48.6	40.2	38.6
Leverage 5/	...	8.3	8.6	9.2	9.3	9.4	9.0	10.1	9.5
Liquidity (percent) 6/	...	79.5	91.4	92.5	99.2	105.4	82.8	63.1	68.2
Profitability (percent) 7/	...	5.1	4.1	7.9	12.1	10.0	-14.4	-24.4	-14.2
Memorandum items									
Nominal GDP (millions of euros)	1,418	1,512	1,575	1,668	1,756	1,732	1,575	1,492	1,472

Sources: CBSM; UPECEDS; and IMF staff calculations.

1/ Include, for example, insurance agencies.
2/ As of June 2011.
3/ Include both assets on balance sheets and assets under management.
4/ Includes taxes on profits and financial withholding taxes (paid by both residents and nonresidents); the number for 2010-11 are estimated.
5/ As the ratio of total assets to capital.
6/ As the ratio of liquid assets to short-term liabilities.
7/ Return on equity based on net profits before provision to fund for general banking risk.

Table 3. San Marino: Financial Soundness Indicators, 2007-11

	2007	2008	2009	2010	2011	Latest Data
Capital adequacy ratios (percent)						
Regulatory capital to risk-weighted assets	17.5	16.9	16.9	15.6	15.4	Jun-11
Capital to assets	10.8	10.7	11.1	9.9	10.6	Jun-11
Asset quality ratios (percent)						
Nonperforming loans to total loans	0.9	2.6	2.9	5.1	10.2	Dec-11
Problem loans to total loans	...	4.2	8.5	15.0	17.0	Jun-11
Nonperforming loans net of provision to capital	...	...	7.2	17.6	20.9	Jun-11
Problem loans net of provision to capital	...	...	22.9	52.5	34.8	Jun-11
Loan loss provision to total loans 1/	4.3	2.6	3.9	6.3	11.0	Jun-11
Earning and profitability (percent)						
Return on assets (ROA) 2/	1.2	0.8	-1.4	-2.7	-5.9	Jun-11
Return on assets (ROA) 3/	1.3	1.1	-1.6	-2.6	-1.4	Jun-11
Return on equity (ROE) 2/	10.7	7.6	-13.1	-25.2	-57.7	Jun-11
Return on equity (ROE) 3/	12.1	10.0	-14.4	-24.4	-14.2	Jun-11
Interest margin to gross income	81.2	100.9	51.4	49.0	62.5	Jun-11
Non-interest expenses to gross income	36.7	45.2	52.2	68.5	77.9	Jun-11
Trading income to gross income	-7.8	-29.1	11.0	1.3	0.6	Jun-11
Administrative expenses to non-interest expenditures	84.0	83.5	51.3	61.9	73.0	Jun-11
Liquidity (percent)						
Liquid assets to total assets 4/	37.2	38.3	25.5	17.1	14.9	Dec-11
Liquid assets to short-term liabilities 4/	96.6	104.3	67.6	56.1	55.1	Dec-11
Loans to deposits	77.1	75.2	88.5	101.4	91.6	Dec-11
Interest rates (basis points)						
Spread between lending and deposit rates	496	567	478	468	480	Jun-11

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

1/ Based on total loan loss provision, which also covers problem loans and performing loans.
2/ Before extraordinary items and taxes.
3/ After extraordinary items and taxes, and before provision to fund for general banking risk.
4/ Liquid assets include cash in vault, loans to banks on demand, and securities. Short-term liabilities include due to banks and customers on demand, and repos.

Table 4. San Marino: Banking System's Consolidated Financial Position, 2008-11

(Millions of euros)

	2008H2	2009H1	2009H2	2010H1	2010H2	2011H1
Balance Sheet						
Assets						
Cash	45	49	43	30	35	34
Loans to banks	1,251	1,083	1,206	1,322	1,445	1,470
Loans to customers	5,129	5,434	4,887	4,642	4,453	3,840
Financial leasing	128	110	109	106	94	108
Bond portfolio and other debt securities	3,917	3,925	2,312	1,647	1,243	1,049
Shares, interests and other equity securities	89	72	61	58	50	44
Equity investment	176	179	130	151	129	125
Other assets	801	684	699	615	643	588
Total assets	11,536	11,537	9,447	8,570	8,091	7,259
Liabilities						
Due to banks	375	164	421	641	465	409
Due to customers	3,166	3,903	3,645	2,895	2,701	2,326
Debt securities	5,996	5,504	3,444	3,213	3,191	3,111
o/w: Certificates of deposit	4,018	3,659	2,568	2,311	2,268	2,279
Fund for risks and charges	82	81	262	207	336	159
Other liabilities	685	587	578	514	497	454
Total liabilities	10,303	10,240	8,350	7,470	7,190	6,458
Equity						
Share	690	690	692	692	704	603
Retained earnings and net profits	300	320	88	62	-179	-33
o/w: Fund for general banking risks	257	261	45	47	39	39
Subordinated debt	0	0	47	55	55	55
Other reserves	242	287	269	292	320	176
Total equity	1,232	1,297	1,097	1,101	900	801
Off-balance Sheet Activities						
Guarantees given	510	407	515	520	484	472
Commitments	2,222	1,729	1,300	1,257	1,109	1,016
Total guarantees and commitments	2,732	2,136	1,816	1,777	1,593	1,488
Income Statement (annualized)						
Net interest income	...	193	170	119	108	100
Interest income and similar revenues	...	360	284	209	207	200
Interest expense and similar charges	...	-167	-114	-90	-99	-100
Non-interest income	...	76	268	95	141	60
Gross income	...	269	438	214	249	161
Non-interest expense	...	-96	-273	-128	-189	-125
o/w: Administrative costs	...	-84	-105	-93	-104	-91
o/w: Write-downs of fixed assets	...	-6	-161	-31	-79	-30
Net income before writedowns and provisions	...	173	165	86	60	36
Writedowns and provisions	...	-23	-613	-56	-556	-487
o/w: Loans, and Gaurantees and Commitments	...	-18	-116	-56	-198	-374
Net income from ordinary activity	...	151	-449	30	-495	-452
Net income from extraordinary activity	...	-6	-10	5	16	346
Income tax expense	...	-8	-8	-4	-2	-5
Net profits before provision to "fund for general banking risk"	...	137	-466	31	-482	-111
Change in "fund for general banking risk"	...	-9	433	-4	16	0
Net profits after provision to "fund for general banking risk"	...	128	-33	27	-466	-111
Capital Adequacy						
Regulatory capital	1,035	960	919	935	748	634
Risk-weighted assets	6,118	6,232	5,423	5,126	4,783	4,114

Sources: CBSM; and IMF staff calculations.

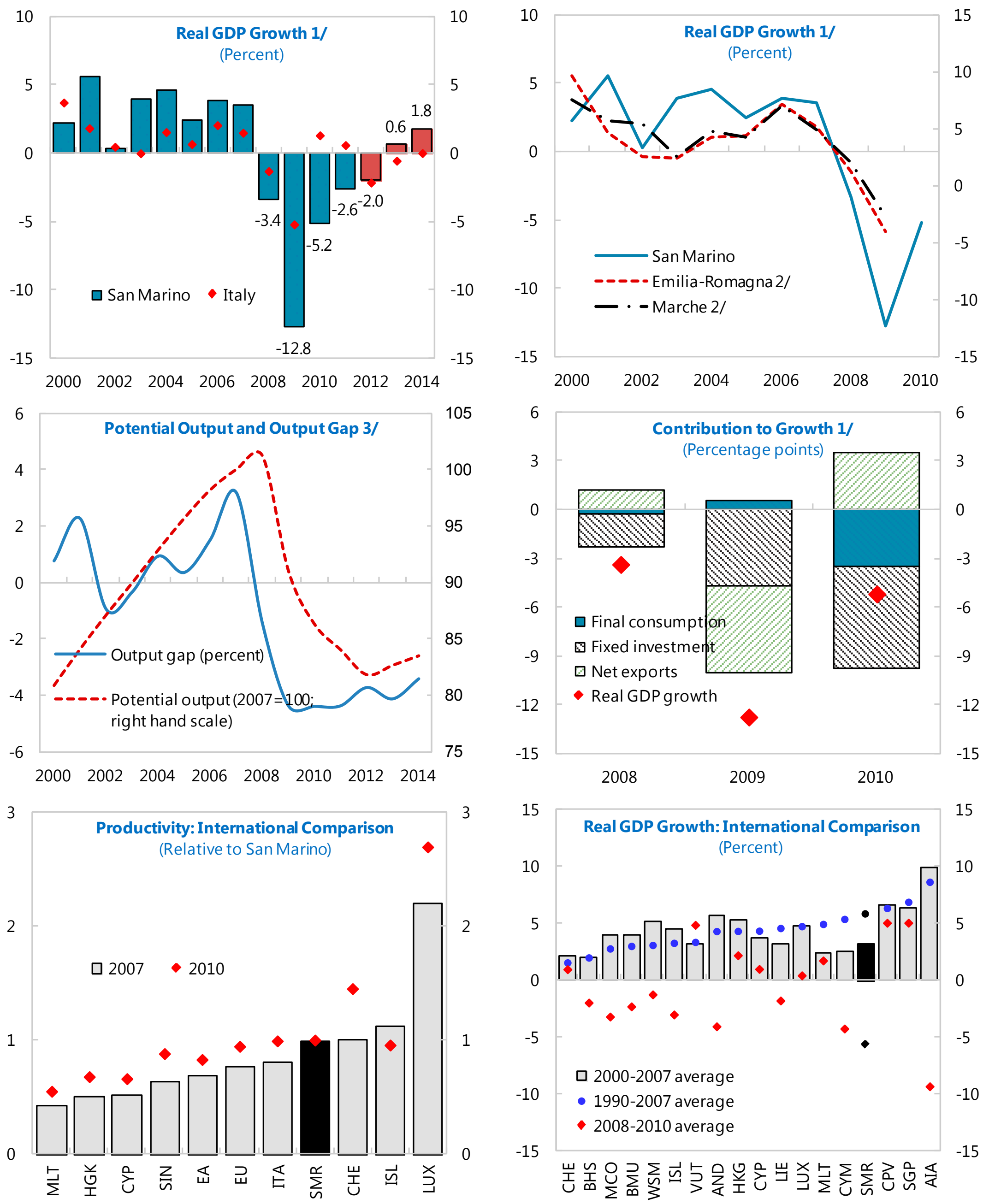
Table 5. Statement of Operations for Budgetary Central Government of San Marino, 2007-12

(Percent of GDP)

					Estimate	Budget	Projection
	2007	2008	2009	2010	2011	2012	2012
Revenue	22.7	21.4	21.0	22.7	20.3	21.9	21.1
Taxes	18.7	17.3	16.2	17.6	15.4	17.0	16.2
Income taxes	6.4	6.7	6.4	7.4	6.5	6.5	6.4
Non-income taxes	12.3	10.6	9.8	10.1	8.8	10.5	9.8
Taxes on international trade and transactions	9.2	7.4	6.6	7.1	6.2	6.4	6.5
Other taxes	3.2	3.2	3.1	3.0	2.7	4.0	3.4
Non-tax revenue	4.0	4.1	4.8	5.1	5.0	4.8	4.9
Expenditure	21.1	21.2	23.3	24.8	23.2	24.2	24.3
Expense	19.6	19.5	21.8	23.9	22.2	21.8	22.2
Compensation of employees	6.2	6.5	7.3	7.9	8.0	8.1	8.1
Use of goods and services	1.5	1.7	1.9	2.0	2.1	2.2	2.2
Interest	0.2	0.2	0.1	0.1	0.1	0.2	0.2
Grants	8.6	9.7	11.3	11.3	10.4	10.2	10.3
To other general government units	8.6	9.7	11.3	11.3	10.4	10.2	10.3
Current	7.4	8.0	9.1	9.4	8.8	9.2	9.2
Capital	1.2	1.6	2.2	1.9	1.6	0.9	1.1
Other expenses (including subsidies)	3.2	1.5	1.1	2.7	1.6	1.2	1.4
Net acquisition of non-financial assets	1.4	1.7	1.5	0.9	1.0	2.4	2.1
Asset sales	0.0	-0.2	-0.1	0.0	-0.3	-0.1	-0.1
Other	1.5	1.9	1.6	0.9	1.4	2.5	2.2
Gross Operating Balance	3.1	1.9	-0.8	-1.3	-1.9	0.0	-1.1
Net lending (+)/borrowing (-) (fiscal balance)	1.7	0.2	-2.3	-2.1	-2.9	-2.3	-3.2
Net financial worth, transactions	1.7	0.2	-2.3	-2.1	-2.9	-2.3	-3.2
Net acquisition of financial assets	3.7	1.0	-6.4	-4.4	-4.4	0.0	0.0
Currency and deposits	1.3	2.9	-0.4	-2.6	-4.4	0.0	0.0
Other accounts receivable	2.5	-1.8	-6.0	-1.8	0.0	0.0	0.0
Net incurrence of liabilities	2.1	0.9	-4.1	-2.3	-1.4	2.3	3.2
Loans	-0.2	-0.2	-0.3	-0.5	-0.6	2.3	3.2
Other accounts payable	2.3	1.1	-3.8	-1.8	-0.9	0.0	0.0
Consolidated Budgetary Central Government (BCG) and Social Security Fund (SSF)							
Revenue	32.2	31.9	33.2	35.1	35.0	37.1	36.4
Expenditure	30.0	31.9	35.5	37.3	37.9	39.3	39.4
Overall balance	2.2	0.0	-2.3	-2.2	-2.9	-2.2	-3.0
Memorandum items							
Government debt	11.8	14.7	18.9	19.1	17.9	...	21.2
Loans	3.7	3.8	4.0	3.8	3.3	...	6.5
Net accounts payable	8.1	10.9	14.9	15.3	14.6	...	14.8
Government deposits	12.2	15.2	16.3	14.6	10.5	...	10.6
Nominal GDP (millions of euros)	1,756	1,732	1,575	1,492	1,472	...	1,459
Real GDP growth (percent)	3.5	-3.4	-12.8	-5.2	-2.6	...	-2.0
Change in GDP deflator (percent)	1.7	2.0	4.2	-0.1	1.2	...	1.4

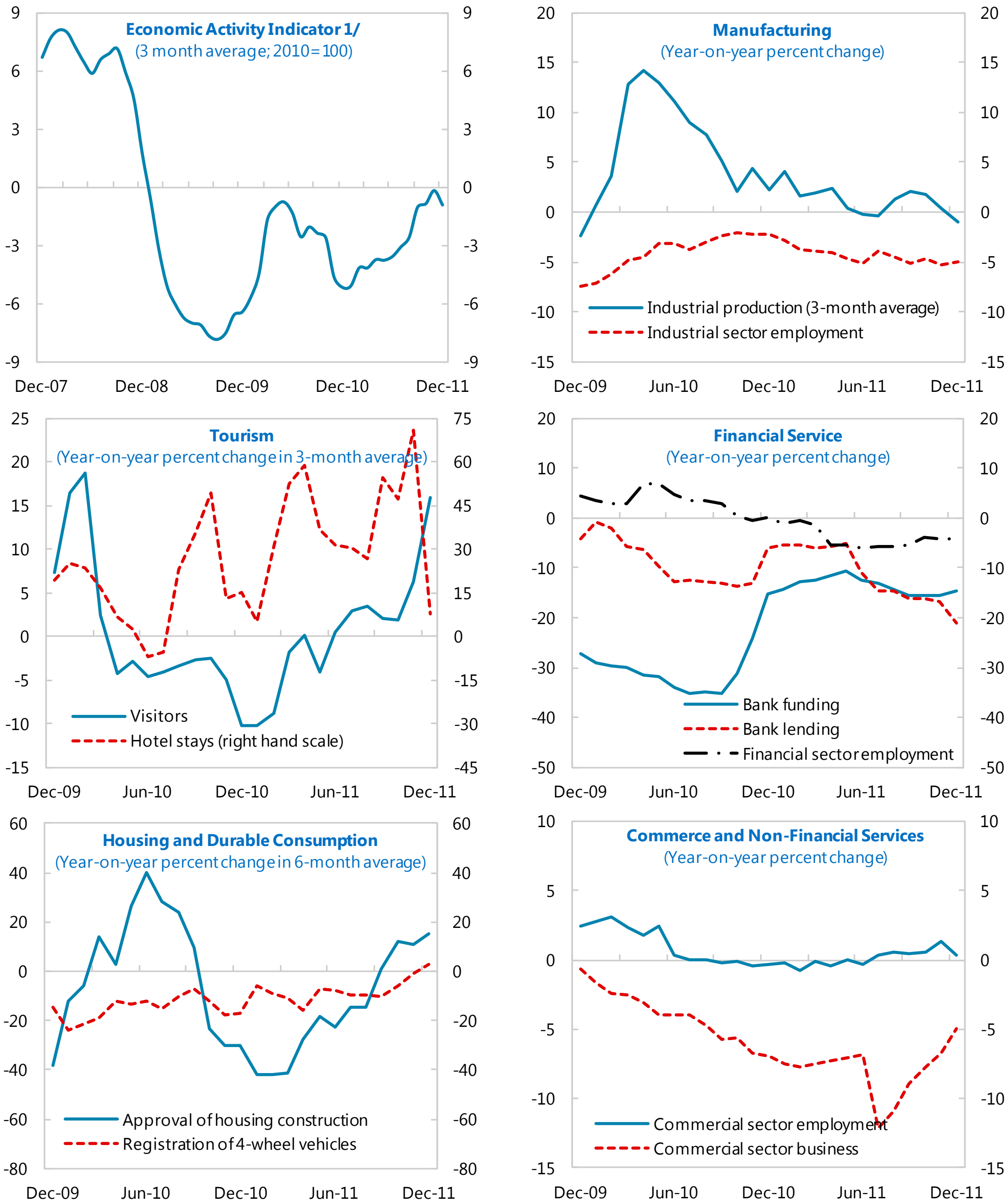
Sources: Sammarinese authorities; and IMF staff calculations and projections.

Figure 1. San Marino: Output Developments, 2000-14



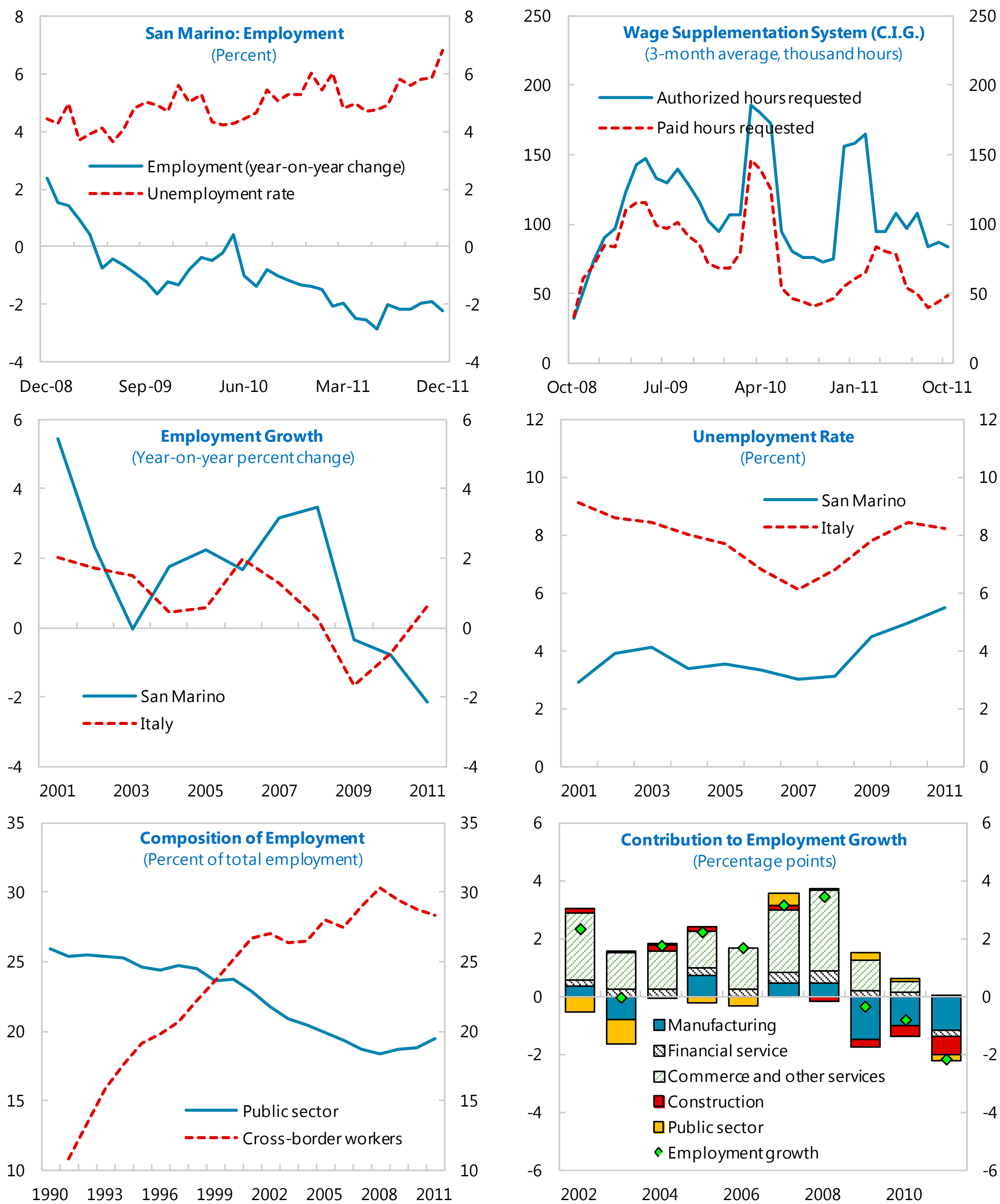
Sources: IMF, World Economic Outlook; United Nations; UPECEDS; and IMF staff calculations, estimates and projections.
1/ For 2007-2010, based on new preliminary expenditure-based national accounts statistics as part of technical assistance by STA. For pre-2007, based on old income-based national accounts statistics.
2/ Emilia-Romagna and Marche are the two Italian regions that surround San Marino.
3/ For years up to 2008, potential output is derived from the HP filter. For years after 2008, potential output is estimated based on certain assumptions of permanent output contraction during the crisis and post-crisis economic growth.

Figure 2. San Marino: Recent Activity Indicators, 2009-11



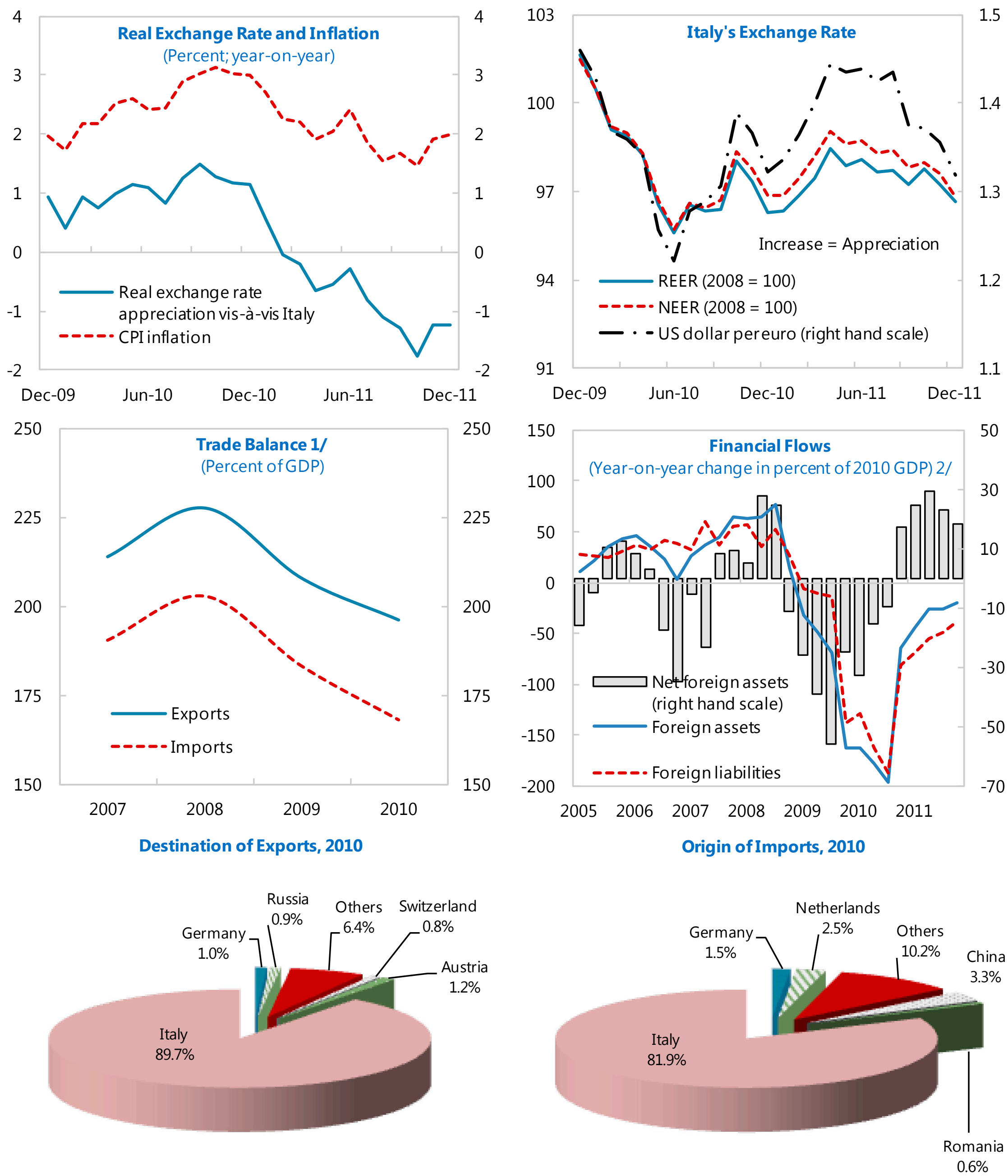
Sources: CBSM; ISTAT; UPECEDS; and IMF staff calculations.
1/ Constructed based on activity indicators for commerce, construction, financials, manufacturing and tourism, weighted by each sector's contribution to GDP.

Figure 3. San Marino: Labor Market Developments, 1990-2011



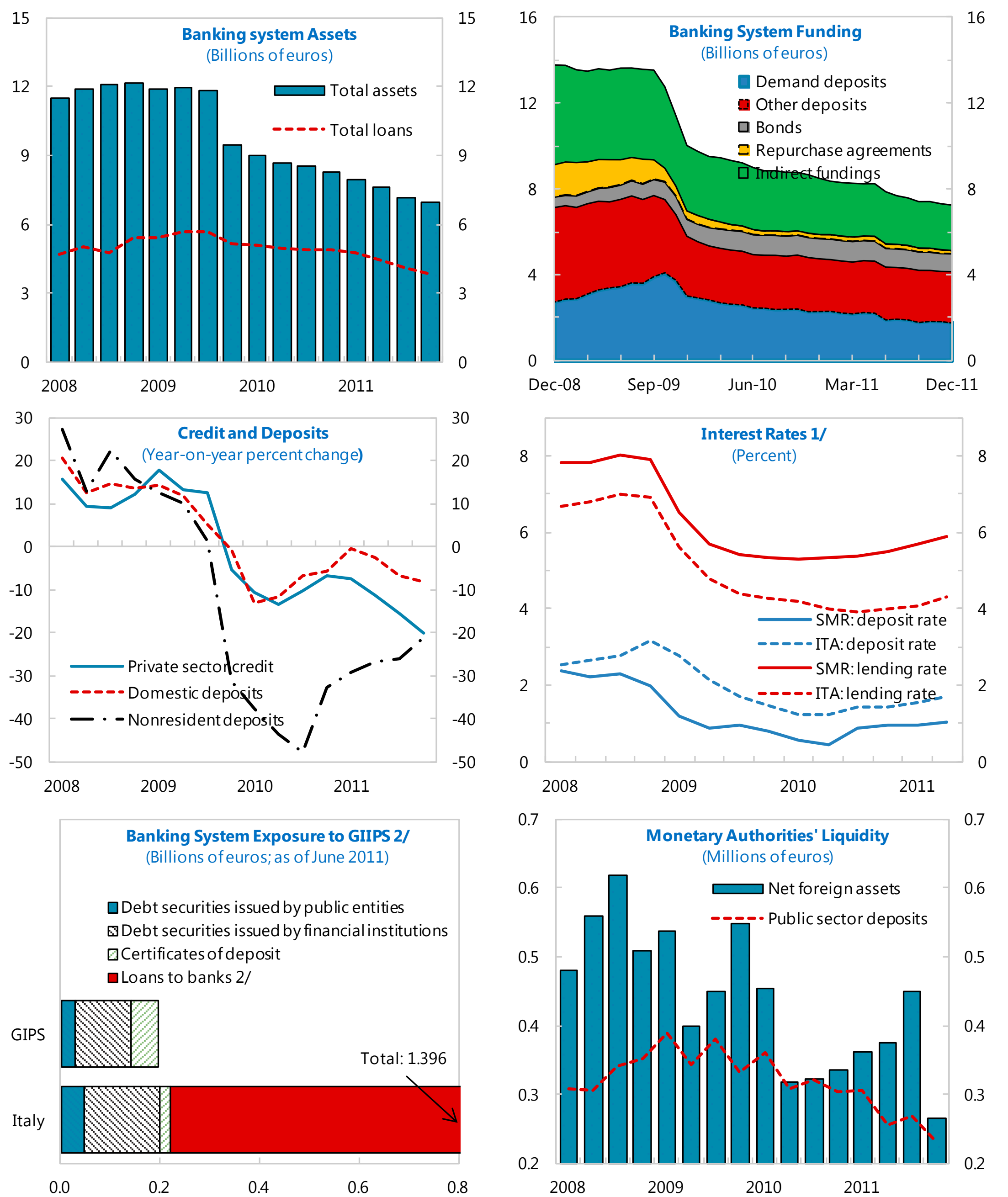
Sources: IMF, World Economic Outlook; ISTAT; UPECEDS; and IMF staff calculations.

Figure 4. San Marino: External Sector Indicators, 2005-11



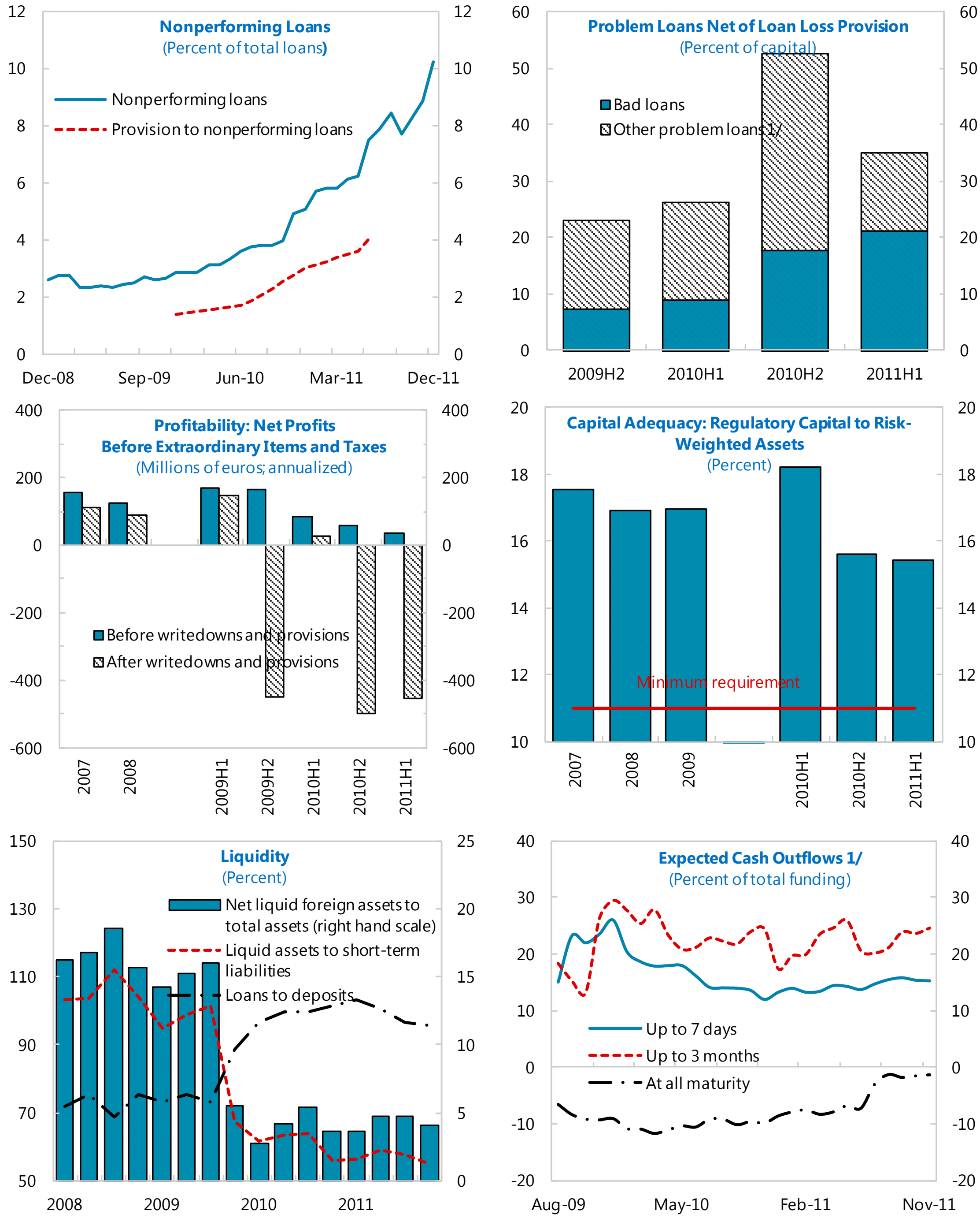
Sources: CBSM; IMF, Information Notice System and International Financial Statistics; UPECEDS; and IMF staff calculations.
1/ Based on national accounts statistics; including goods and services.
2/ Based on foreign assets and liabilities of banks and monetary authorities; a positive (negative) change in net foreign assets implies net financial outflow (inflow). Change in foreign assets (liabilities) reflects financial outflow (inflow).

Figure 5. San Marino: Financial Sector Indicators, 2008-11



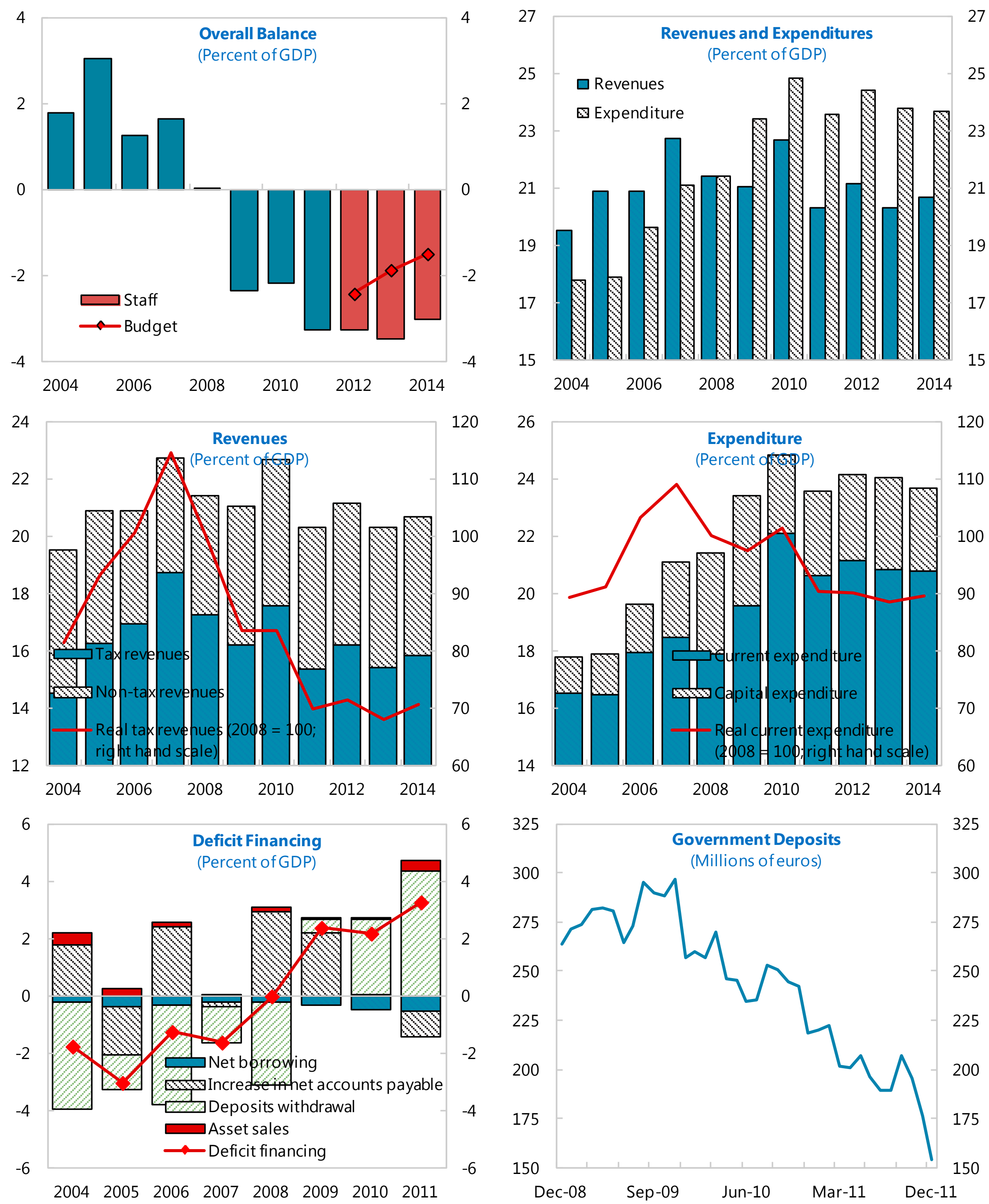
Sources: CBSM; IMF, International Financial Statistics; UPECEDS; and IMF staff calculations and estimates.
1/ For San Marino, based on time deposit rate. For Italy, based on deposit rate for households with maturity up to 2 years (stock basis). Based on comparable series (which was discontinued in 2003), deposit rates in San Marino were higher by aboout 1 percentage point.
2/ GIIPS include Greece, Ireland, Italy, Portugal and Spain.
3/ Assume that 90 percent of bank loans are extended to Italian banks, with the remaining bank loans extended to non-GIPS banks.

Figure 6. San Marino: Banking System Financial Soundness Indicators, 2007-11



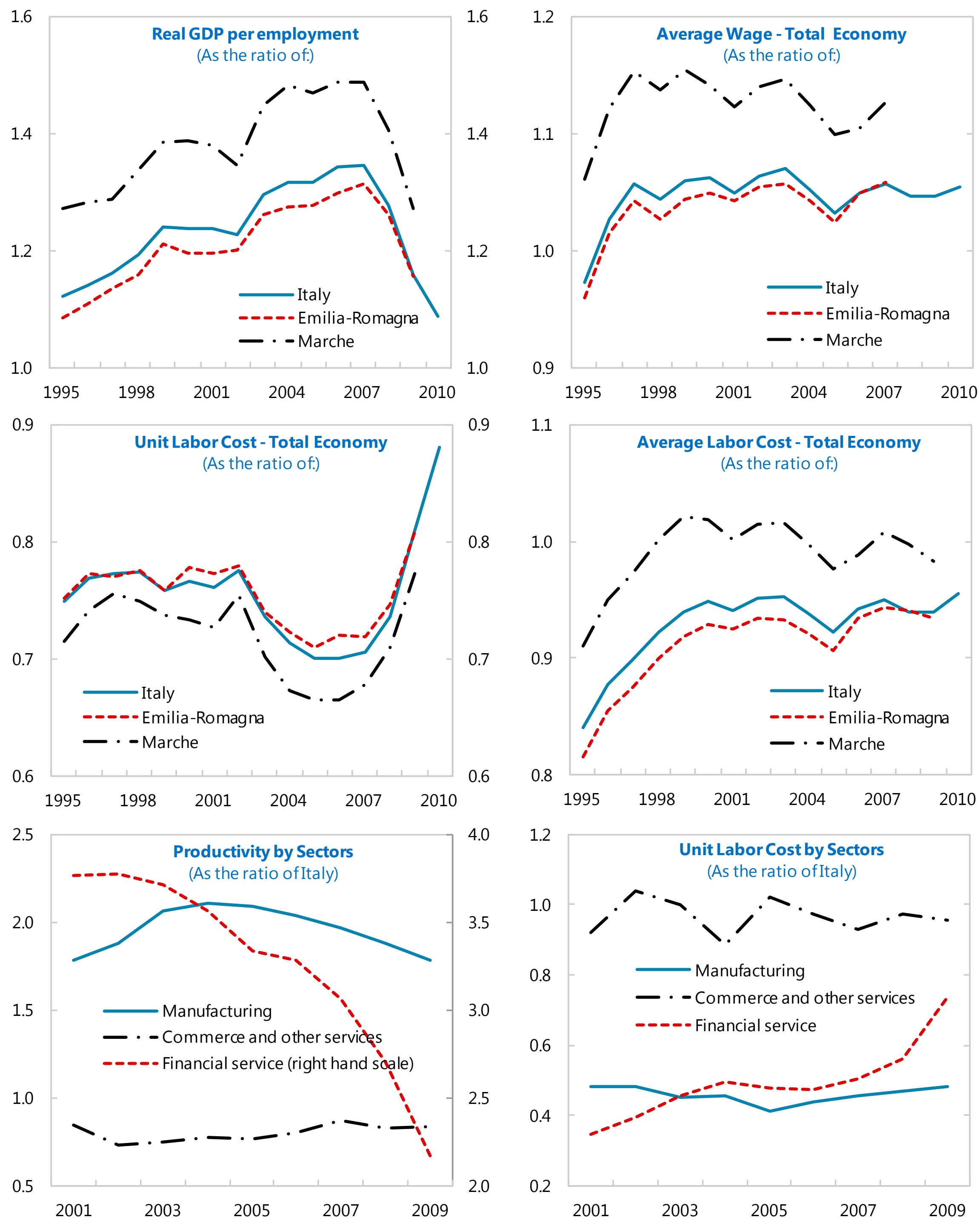
Sources: CBSM; IMF, International Financial Statistics; UPECEDS; and IMF staff calculations.
1/ Based on difference between liabilities and assets that will reach their maturity within a specified horizon.

Figure 7. San Marino: Fiscal Indicators, 2004-14 1/



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations and projections.
1/ For the budgetary central government.

Figure 8. San Marino: Competitiveness Indicators, 1995-2010 1/



Sources: IMF, World Economic Outlook; ISTAT; UPECEDS; and IMF staff calculations.
1/ Emilia-Romagna and Marche are the two Italian regions that surround San Marino.

ANNEX I. RISK ASSESSMENT MATRIX[1]

Nature/Source of Main Threats	Overall Level of Concern	
	Likelihood of Severe Realization of Threat in the Next 1-3 Years (high, medium, or low)	**Expected Impact if Threat is Realized** (high, medium, or low)
1. Intensification of the euro area debt crisis and global double-dip recession	**Medium** The euro area debt crisis remains a key global risk, and its intensification could worsen economic and financial developments in Italy.	**Medium** In 2012, San Marino's real GDP contraction could worsen to 4.2 percent. Significant erosion in bank capital is likely on the back of rapidly rising NPLs and sharply worsening quality of assets with exposure to Italy. Budget deficits will be larger, with limited financing options.
2. Heightened stress in a systemically important financial institution	**Medium** CRSM needs to be recapitalized following substantial losses associated with its investment in the Delta group. The bank could become under-capitalized if losses are larger than expected or the existing recapitalization plan fails.	**High** CRSM is a systemic institution and affects confidence in the banking system as a whole. Government financing is challenging, especially if the government needs to provide support to the financial sector, as it has no experience in accessing capital markets.
3. Continuing strained relations with Italy	**Low** Although the Italian government recently signaled its willingness to reengage, the time frame for ratifying of the double tax treaty, a key prerequisite for implementing cooperation agreements and normalizing relations, remains unclear.	**Medium** Much of the impact of the strained relations has been felt. San Marino's growth prospects will be further hampered. The lack of cooperation agreements also undermines the ability of the economy to adapt towards a new growth model.
4. Failure to adopt a new growth model	**Medium** Potential GDP is estimated to have contracted by 16 percent in recent years, primarily due to the significant compression of financial institutions' balance sheets as well as a sharp decline in the manufacturing base. There is no clear progress made by the financial sector to adopt a new business model, while the manufacturing sector will face stiffer competition from countries with lower labor costs.	**Medium** San Marino's long-term growth prospects will be significantly dimmer. The fiscal position will be weaker as tax revenues will be permanently lower.

[1] Prepared by Phakawa Jeasakul.

ANNEX II. ACTIONS TAKEN TO MEET THE FSAP RECOMMANDATIONS[1]

Recommendation	Actions Taken
Secure contingent emergency lines of credit with other central banks.	As yet no other central bank has agreed to provide such credit.
Recapitalize banks that do not meet prudential requirements.	Four banks were below capital requirements in June 2011. Three were placed in special administration for various reasons and then either forced to close or be acquired by other banks. One of the four has been recapitalized and has itself acquired another bank.
Strengthen supervision, particularly full on-site inspections.	Total staff in supervision department of CBSM were 29 in February 2012, with three further staff approved by management. Staff resources would be adequate for supervision of the banks and (much reduced) fiduciary and finance companies) except for the diversion of CBSM supervision resources to undertake investigations for the judicial authority (80 percent of supervision staff were required for this purpose in the first two months of 2012). Recruitment of staff from outside San Marino continues to be constrained by the labor law and Labor Office, although labor market reform should ease the problem. Total number of inspections remained constant (24) but more focus was placed on banks. The closure of banks and financial companies was due in part to regulatory breaches discovered through on site supervision.
Facilitate cross-border flows of information and allow foreign supervisors to make on-site visits to foreign banks in San Marino.	Further amendments made to Article 36 of Law 165 to clarify that subsidiaries may pass information to parent banks for risk management by bank parent. Article 36 also amended to allow on-site inspections by foreign supervisors where an agreement exists between the CBSM and the foreign supervisor.
Ensure that financial institutions, particularly fiduciary firms, are properly and effectively implementing the customer due diligence (CDD) requirements.	On-site inspections by CBSM concerning AML/CFT issues increased from four in 2009 to 13 in 2010. Ten inspections were conducted in 2011, despite the reduced number of companies.
Introduce a new governance model for the CBSM.	Some changes made to Governance: • CBSM Governing Council (GC) given greater responsibility for actions of CBSM; • Role of State Congress in special administration removed; • Unanimous vote of GC now required to remove Director General; • Role of State Congress and Committee for Savings and Credit removed from appointment of GC and members of parliament may now nominate candidates for approval by the parliament; • Additional list of positions incompatible with membership of GC. However: • No change to State Congress ability to refuse a license approved by CBSM and no criteria exist for such decisions; • Law does not specify limited grounds for dismissal of DG; • No change in transparency of appointment procedure of GC members.

[1] Prepared by Richard Pratt.

Recommendation	Actions Taken
Introduce prudential measures that contain banks' liquidity risks (such as minimum liquidity ratios with the CBSM).	Reserve requirement of 8 percent of total deposits, waived for banks that provide liquidity to other banks. Voluntary scheme for depositing excess liquidity with CBSM. New Decree-Law enacted to permit CBSM to act as lender of last resort.
Upgrade financial regulation, preferably in line with the EU framework.	Prudential rules for finance and fiduciary companies have been introduced in line with those for banks (and their enforcement has prompted many firms to exit the business). The monetary agreement with the EU, signed in March 2012, commits the CBSM to bringing supervision into line with EU directives within six years.
Take all possible steps to accelerate the transition period to full compliance with the regulations on loan concentration.	No change to transitional measures. However, four of the banks with weak capital have been closed or merged and the transitional measures will, in any case, end by January 2014.
Increase staff of the Financial Intelligence Agency (FIA), the CBSM supervision units and the Judiciary responsible for AML/CFT.	In April 2010, FIA requested increased staff. The request was partially granted but only in 2012.
Introduce measures to facilitate self-insurance among banks.	See description of liquidity measures above. Some banks have secured lines of credit with foreign banks
Finalize supervision manuals.	On-site supervision manual finalized. Off-site supervision manual is being prepared. Risk assessment of liquidity and capital risk is formalized in a weekly and quarterly review process.
Seek to obtain access to the EU payment system, and ECB refinancing facilities.	Access sought but not yet achieved.
Undertake reform of fiduciary companies in order to strengthen transparency in corporate ownership and clarify the scope of activities in which these companies can engage.	Bearer shares prohibited, corporate liability of legal persons has been introduced. Regulation of fiduciary companies, in line with prudential regulations for banks was introduced in 2011. Number of financial companies decreased from 59 in 2008 to 25 in 2012. Assets under management by fiduciary companies reduced from €3.3 billion in June 2009 to €790 million in June 2011.
Enhance collaboration between the FIA and the CBSM in the area of financial sector AML/CFT supervision.	Some increased coordination between FIA and CBSM: • Agreed risk assessment undertaken of institutions in respect of AML/CFT; • Exchange of information on all AML/CFT matters found in inspections, including reporting findings during inspections; • Review meetings held to reassess risk of institutions. However, joint inspections remain rare.
Reconsider some of the FIA's non-core financial intelligence unit's (FIU) responsibilities (such as the power to act as judicial police on delegation from the judicial authority) in the light of the FIA's limited human resources.	No change to responsibilities.

ANNEX III. DEBT SUSTAINABILITY[1]

1. San Marino's government debt level has risen significantly over the last year, primarily due to the reclassification of net accounts payable (NAP) as debt (Figure IV.1). Over the years, due to the lack of access to capital markets, the government has borrowed largely in the form of secured loans primarily from domestic banks. These loans amounted to 3½ percent of GDP at end-2011.[2] At the same time, the government has accumulated substantial accounts receivable (AR) and accounts payable (AP), with the amount of the NAP totaling 14½ percent of GDP. Staff, with the help of an STA expert who joined the Article IV mission, considers that the NAP should be classified as part of government debt. Hence, the debt level was revalued at 18 percent of GDP at end-2011.

2. The stocks of both AR and AP are substantial. At end-2010, the level of AR was around 35 percent of GDP, while the level of AP was 49½ percent of GDP. The AP mainly consist of tax refunds (47 percent of total AP), transfers to other public entities (26 percent), and provisions made against potentially uncollectable AR (18 percent), while deferred payments to suppliers are relatively small (up to 10 percent). Meanwhile, tax receipts account for 85 percent of AR. In particular, the import tax system is the main source of AR and AP, accounting for about 65 percent of AR and AP during 2004–10, mainly because net import tax payments are usually settled with very long lags.

3. Both AR and AP were subject to adjustment by staff, so as to properly account for government's liabilities. Outstanding AP and AR are composed of both newly accrued as well as carry-over items. While AR and AP tend to be short-term items (i.e. being cleared within few months), in San Marino a large portion of carry-over items have been neither collected nor paid. During the 2002-10 period, carry-over items from previous years accounted for 28 percent of AR, and 40 percent of AP. Some of these have stayed on the accounts for more than ten years. This feature partly results from the authorities' practice that uncollectable AR are not written off until a judiciary process is finalized, although provisions have been made fully against them. The provisions against theses uncollectable AR are included in AP. Hence, the official figures of AR and AP are somewhat overstated and staff had to adjust them to properly account for the new debt level.

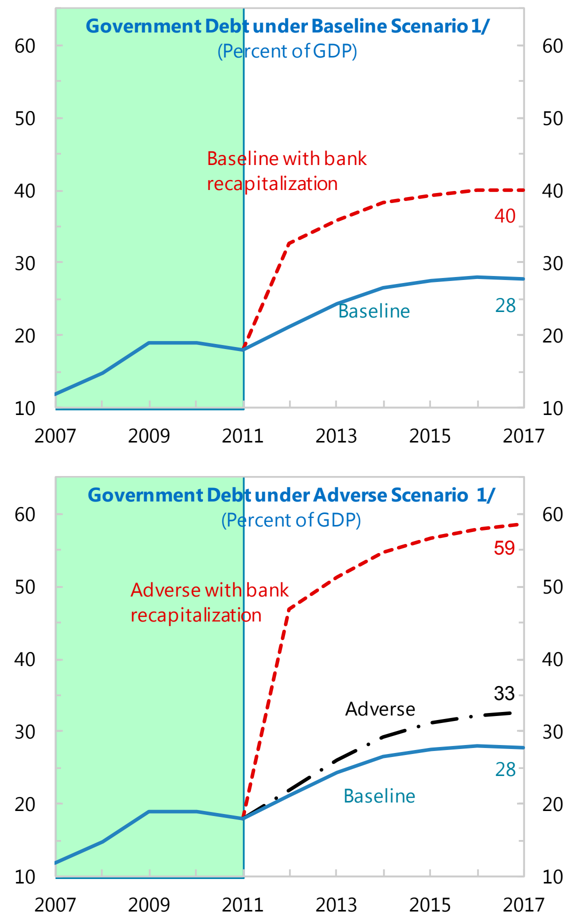
4. Debt sustainability analysis points to an upward trend in the debt over the medium term (Figure IV.2). Government debt has been on an upward trajectory in recent years, largely due to an increase in NAP. Government debt is projected to rise from 18 percent of GDP in 2011 to 28 percent of GDP in 2017, as the budget is expected to remain in deficits over the medium term. The baseline scenario is constructed on the following assumptions: (i) a slow increase in tax revenues on the back of the weak economic outlook

[1] Prepared by Phakawa Jeasakul and Alberto Jiménez de Lucio.

[2] Relative to GDP, the level of these loans is lower than that in the previous staff report, mainly due to an upward revision of nominal GDP. Changes in the nominal value of these loans only resulted from a small amortization.

over the medium term; (ii) an increase in real expenditure of about 0.3 percent annually on average after 2013 to reflect the government's attempt to control expenditure; (iii) no financing in the form of accumulation in NAP and withdrawal of deposits from 2012; and (iv) no government participation in bank recapitalization. The debt dynamics appears to be most sensitive to a shock to the assumed fiscal adjustment effort and the contingent liability shock, but are less sensitive to an interest rate shock.

5. Potential needs to recapitalize banks could push the level of government debt significantly higher in the medium term. Government debt could reach 40 percent of GDP by 2017 in the event that the government needs to partake in bank recapitalization, with 100 percent of bank recapitalization (indicated by stress tests) being financed by the government (net of €20 million committed by CRSM's existing shareholders). Under an adverse scenario, government debt could reach 59 percent of GDP.[3]



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations, estimates and projections.
1/ Assume that 100 percent of bank recapitalization needs indicated by stress tests are financed by the government (net of €20 million committed by CRSM's existing shareholders).

[3] This adverse scenario envisages larger budget deficits (by 1 percent of GDP per year on average over the medium term) in addition to larger bank recapitalization needs as indicated by the stress tests.

Table III.1. San Marino: Government Debt Sustainability Framework, 2006-17

(Percent of GDP, unless otherwise indicated)

	Actual					Projections							Debt-stabilizing primary balance 9/
	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	
Baseline: Government debt 1/	13.3	11.8	14.7	18.9	19.1	**17.9**	**21.2**	**24.2**	**26.5**	**27.5**	**28.1**	**27.8**	**0.4**
Change in government debt	-0.3	-1.4	2.8	4.2	0.1	-1.1	3.3	3.0	2.3	1.1	0.6	-0.3	
Identified debt-creaing flows	1.4	-0.9	2.6	2.2	-0.5	-1.4	3.1	3.2	2.6	1.6	0.9	0.1	
Primary deficit	-1.4	-1.8	-0.2	2.2	2.1	3.2	3.1	3.3	2.7	1.5	0.8	-0.1	
Revenue	20.9	22.7	21.4	21.0	22.7	20.3	21.1	20.3	20.7	21.3	21.7	22.3	
Non-interest expenditure	19.5	20.9	21.2	23.3	24.8	23.5	24.2	23.6	23.3	22.9	22.5	22.2	
Automatic debt dynamics 2/	-0.1	0.0	0.3	0.5	0.3	0.2	0.1	0.1	0.1	0.0	0.1	0.2	
Contribution from interest rate and growth differential 3/	-0.1	0.0	0.3	0.5	0.3	0.2	0.1	0.1	0.1	0.0	0.1	0.2	
Of which: from real interestrate	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.2	0.3	0.3	0.4	
Of which: from real GDP growth	-0.2	-0.1	0.1	0.5	0.2	0.1	0.0	0.0	-0.2	-0.3	-0.2	-0.2	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating dynamics	2.9	0.9	2.6	-0.5	-2.8	-4.7	-0.1	-0.1	-0.1	0.0	0.0	0.0	
Reduction in deposits (entered as negative)	3.4	1.3	2.9	-0.4	-2.6	-4.4	0.0	0.0	0.0	0.0	0.0	0.0	
Asset sale (entered as negative)	-0.1	0.0	-0.2	-0.1	0.0	-0.3	-0.1	-0.1	-0.1	0.0	0.0	0.0	
Recognition of contingent or implicit liabilities	-0.4	-0.3	-0.1	0.0	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Bank recapitalization	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residuals 5/	-1.7	-0.5	0.2	2.0	0.6	0.2	0.2	-0.2	-0.4	-0.5	-0.4	-0.4	
Government debt to revenue ratio 1/	63.5	52.1	68.6	90.0	84.1	88.2	100.6	119.4	128.2	129.2	129.6	125.0	
Gross financing need 6/	-0.6	-1.2	0.8	2.9	2.7	3.8	3.8	4.0	3.5	2.5	1.8	0.9	
Millions of euros	-10.7	-20.9	13.2	46.3	40.7	56.2	55.9	59.9	53.9	39.5	29.8	15.7	
Millions of U.S. dollars	-14.0	-30.7	18.4	66.7	54.4	78.9	75.4	80.1	71.6	52.1	39.0	20.6	
Scenario with key variables at their historical averages 7/	...	...	...	...	...	**17.9**	**17.5**	**16.6**	**15.5**	**14.4**	**13.3**	**12.2**	**0.4**
Scenario with no policy change (constant primary bal.) in 2012 - 2017	...	...	...	...	...	**17.9**	**21.3**	**24.2**	**26.9**	**29.6**	**32.6**	**35.6**	**0.5**
Key macroeconomic and fiscal assumptions													
Real GDP growth (percent)	3.8	3.5	-3.4	-12.8	-5.2	-2.6	-2.0	0.6	1.8	2.5	1.7	1.5	
Inflation (change in GDP deflator, percent)	2.0	1.7	2.0	4.2	-0.1	1.2	1.1	1.4	1.0	1.1	1.2	1.2	
Nominal interest rate (percentage points) 8/	4.3	5.0	6.0	4.0	2.6	4.3	5.1	3.3	3.6	3.8	3.9	4.1	
Real interest rate (percent)	2.3	3.2	4.0	-0.2	2.7	3.1	4.0	2.0	2.6	2.7	2.7	2.9	
Exchange rate appreciation (increase in U.S. dollar value of local currency, percent)	11.6	11.8	-5.5	3.5	-7.2	5.0	-4.0	-0.7	-0.7	-0.7	-0.7	0.0	
Growth of real revenue (percent)	3.8	12.5	-9.0	-14.3	2.2	-12.7	1.9	-3.3	3.6	5.8	3.5	4.2	
Growth of real non-interest expenditure (percent)	14.3	11.2	-2.1	-4.2	0.9	-7.7	1.1	-2.1	0.7	0.5	0.1	0.0	
Primary deficit	-1.4	-1.8	-0.2	2.2	2.1	3.2	3.1	3.3	2.7	1.5	0.8	-0.1	

Sources: Sammarinese authorities, UPECEDS; and IMF staff calculations, estimates and projections.

1/ Based on budgetary central government debt, which includes loans and net account payables.

2/ Derive as [r - π(1+g) - g + αε(1+r)] / (1+g+π+gπ) times previous period debt ratio, with r = nominal interest rate; π = change in GDP deflator; g = real GDP growth; α = share of foreign-currency debt; and ε = nominal exchange rate depreciation.

3/ The real interest rate contribution is derived from the numerator in footnote 2/ as r - π(1+g), and the real GDP growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as αε(1+r).

5/ For projections, this line includes exchange rate changes.

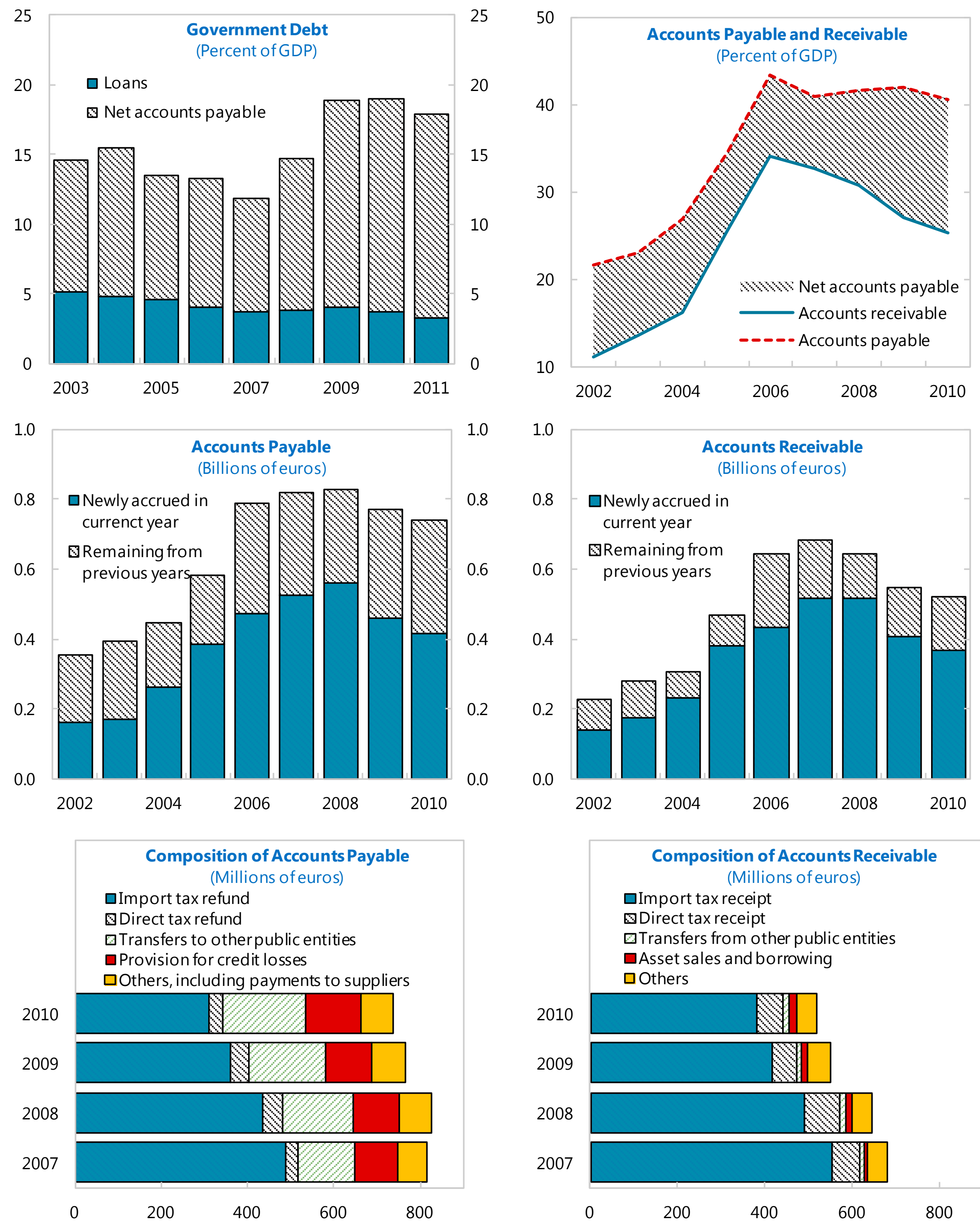
6/ Defined as budget deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt (not being rolled over automatically) at end of previous period, plus extraordinary items (e.g. recognition of contigent or implicit liabilities, and bank recapitalization).

7/ The key variables include real GDP growth, real interest rate, and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by the average of previous and current period debt stock.

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

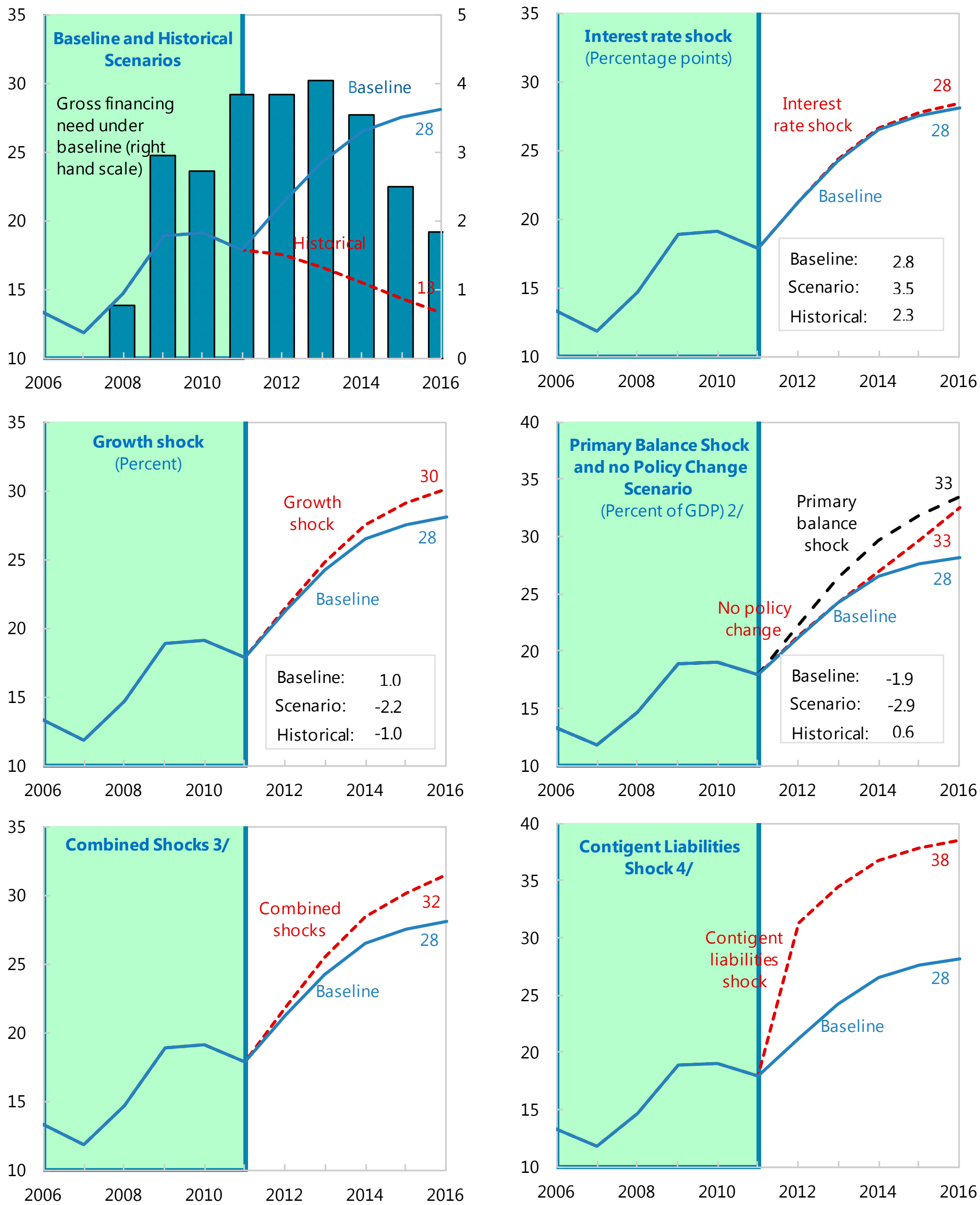
Figure III.1. San Marino: Government Accounts Payable and Receivable, 2002-11 1/



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations.
1/ For the budgetary central government.

Figure III.2. San Marino: Government Debt Sustainability - Bound Tests, 2006-16 1/

(Percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being considered. Seven-year historical average for the variable is also shown. Individual shocks are permanent one-half standard deviation shocks. Government debt is based on budgetary central government debt, which includes loans and net account payables.

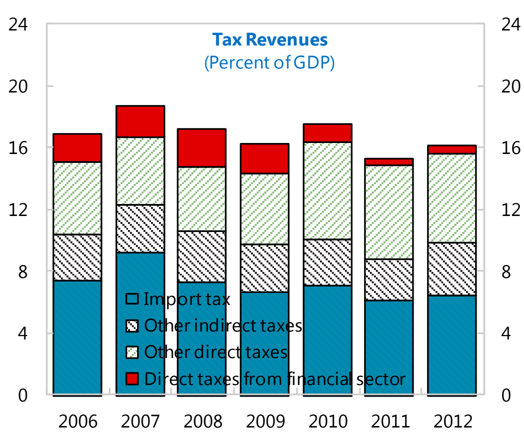
2/ No policy change scenario assumes constant primary balance.

3/ Permanent one-quarter standard deviation shocks applied to real interest rate, real GDP growth, and primary balance.

4/ One-time 10 percent of GDP shock to contingent liabilities in 2012.

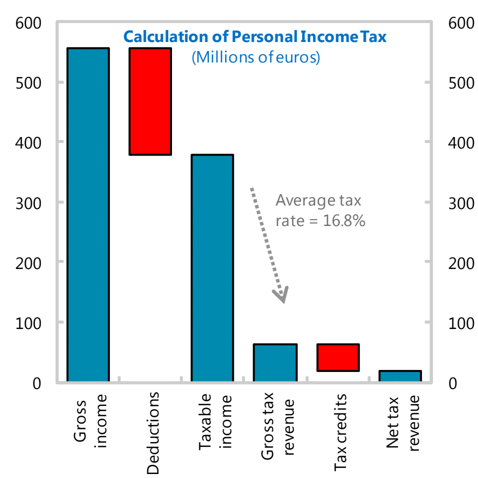
ANNEX IV. A FISCAL CONSOLIDATION STRATEGY[1]

1. **In the absence of fiscal consolidation, San Marino is projected to run large deficits over the medium term.** There has been a marked drop in revenues since the onset of the recession, and some of this decline is expected to be permanent, notably with respect to revenues from the financial sector (estimated at about 2 percent of GDP). Government debt, while still low, is on an upward trajectory and, on announced policies, is projected to reach 28 percent of GDP by 2017. Moreover, large contingent liabilities from the banking sector and uncertain prospects for financing the deficit are important concerns. The past two budgets have made use of ad hoc, temporary measures to cover revenue shortfalls. A more comprehensive medium-term strategy, however, would lend credibility to public finances and provide greater predictability to the economic environment. This note discusses possible options for a fiscal consolidation strategy, and provides information on the authorities' planned fiscal reforms.



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations and estimates.

2. **The tax system is in need of reform.** San Marino has historically been a low tax jurisdiction and has relied on this aspect to maintain a competitive advantage over surrounding Italian regions. Tax revenues as a percentage of GDP are very low by international standards. Moreover, San Marino's income tax system is relatively complex for a small country. For example, the taxation of natural persons is different for employees, self-employed workers, and sole proprietors. Employees may file jointly with their spouses or separately, and there is an extensive range of tax allowances and credits.[2] This means that, although marginal tax rates range from 12 percent to 50 percent, the effective tax rate on personal income is much lower than in comparator countries, at around



Sources: Sammarinese authorities; and IMF staff calculations.

[1] Prepared by Rosalind Mowatt.

[2] The system of tax allowances and credits tends to benefit higher income earners in particular, since the most significant of these are calculated as a percentage of gross income. The system has also created controversy due to certain tax credits being available only to Sammarinese workers and not to the 6,000 or so cross-border workers who live in Italy but work in San Marino.

4½ percent of gross income, or one-third of the average for EU countries. Tax revenues from individuals' income amounts to 2½ percent of GDP, versus an average of 9 to 11 percent for advanced countries.[3]

3. There is no explicit consumption tax in San Marino. Most goods consumed in San Marino are imported, and therefore subject to the *monofase* tax, currently set at 17 percent. Domestically produced goods and services, as well as some imported services, escape taxation. A 3 percent sales tax on certain domestically produced services, such as hotel services, was recently introduced. An informal agreement with Italy stipulates that there should be no more than 5 percentage points difference between the *monofase* rate and the Italian VAT rate.

4. The public administration sector is large relative to the size the economy. The public administration employs 11 percent of workers, compared with an average of 7½ percent for EU countries. Public administration employment is also higher than in other small European economies, such as Malta, Iceland and Cyprus. Moreover, the average wage is higher in the public sector relative to the private sector. Indications are, therefore, that there is some scope to reduce the public sector wage bill, which would also reduce the public sector's dominant position in the labor market.

Staff's proposals

5. Permanent consolidation measures of about 2½ percent of GDP should begin in 2013 and focus on revenue measures (Figure V.1). Staff suggests beginning with a comprehensive consolidation strategy in 2013, when the economy is likely to emerge from recession. Given the low tax revenue to GDP ratio, staff sees greater potential in focusing measures on the revenue side rather than the expenditure side, which is more in line with European averages. Moreover, the fiscal multiplier is relatively low in San Marino, given the high marginal propensity to import. A low fiscal multiplier implies that higher tax revenue collection should not have a significant impact on GDP, since a relatively small proportion of the reduction in disposable income would have been spent on domestically produced goods and services.

Increasing the Revenue Base

6. Staff sees two areas in particular where revenue gains could be easily realized. These are (i) raising the effective tax rate on personal income of employees, self-employed workers and sole proprietors and (ii) increasing indirect tax revenues. Staff has calculated that an increase in the effective rate of personal income tax (PIT) from 4½ percent to 9 percent combined with an increase of around 10 percent in indirect tax revenues could form the backbone of a prudent consolidation strategy.

7. Raising the effective rate of PIT could be achieved through reducing tax allowances and credits. The relatively small suggested increase in the effective rate would yield additional revenue on the order of 1½ percent of GDP annually. Such an increase could easily be achieved without raising marginal tax rates. In fact, a reduction in tax allowances and credits could possibly be combined with a lowering of the top marginal rates, as the authorities envisage in their proposed tax reform.

[3] See "Revenue Mobilization in Developing countries"

8. **There are several ways in which an increase in indirect tax revenues could be achieved.** As noted above, the *monofase* is not applied to all goods and services consumed domestically and so broadening the tax base could yield higher revenues. Options could include extending and possibly raising the rate of the current tax on domestically produced services, and the extension of the special tax on property. Alternatively, the *monofase* rate could be increased. In fact, if the Italian VAT rate is raised later in 2012 to 23 percent, as has been suggested, San Marino will need to increase its *monofase* rate to 18 percent to maintain the 5 percent differential. An increase in the *monofase* rate to 19 percent would mostly cover the suggested 10 percent increase in indirect tax revenues.

9. **The authorities' proposed tax reform goes in the right direction.** A reform strategy for the income tax system is currently under consideration by Parliament. The authorities' proposals rightly focus on reforming the PIT system. The reform proposes reducing tax allowances and credits, and introducing a new system of tax credits aimed at incentivizing the purchase of goods and services produced in San Marino. Moreover, the tax reform unifies rates for various groups and flattens the rate structure for PIT. This is expected to enhance the transparency of the system and encourage compliance. Corporate taxation will remain largely unchanged, except for the introduction of some incentives for large employers. The tax reform also proposes to tax dividends, capital gains, and foreign income for the first time.

10. **Staff's preliminary assessment of the PIT reform suggests savings of around 0.8 percent of GDP.** This is lower than the 1½ percent of GDP savings in staff's proposed consolidation strategy, and would result in an increase in the effective rate of taxation for individuals to 6 percent of gross income. This is still low by international standards and, in staff's view, the authorities could aim for a higher rate, perhaps through a less drastic reduction in marginal tax rates or through a further reduction in tax allowances and credits. In particular, it is not clear that the new tax allowance system is the best way to encourage domestic consumption, since it implies high administrative costs, as the Tax Office will have to process and verify a large number of invoices.

11. **The authorities have also been considering the introduction of a VAT to replace the *monofase*.** A feasibility study is scheduled to be discussed in Parliament in the coming months. In staff's view, however, the authorities' fiscal consolidation strategy should not rely on the proposed VAT to raise additional revenues. While a VAT will broaden the tax base, it may not necessarily raise more revenues than the *monofase*. Much will depend on the rate applied, whether there are

Pros and Cons of Introducing a VAT

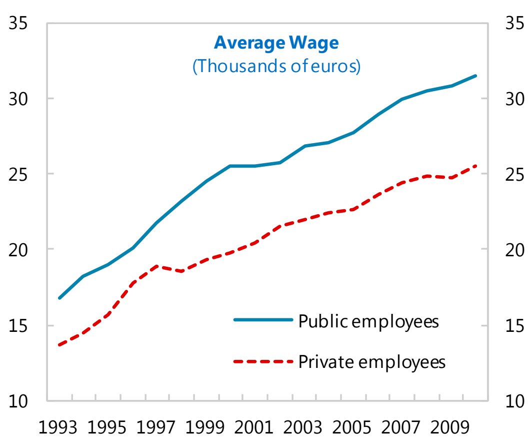
Pros	*Cons*
Covers a broader revenue base and does not distort production incentives, as an import tax does.	More complicated (and therefore costly) to administer than an import tax, which increases the risk of evasion. If there are exemptions, this further increases compliance and administration costs.
A relatively high ratio of trade to GDP is conducive to higher VAT collection, presumably due to the ease of collecting VAT at the point of import.	Countries with a VAT have historically not been more successful in replacing lost trade tax revenue than countries without a VAT.
Distributional implications relatively benign.	As with the *monofase* system, also requires refunds.
Would facilitate integration with European Union economies by permitting, for example, the adoption of the EU VAT Directive.	Costs of compliance are higher than the import tax for businesses.

Sources: IMF (2011) "Revenue Mobilization in Developing Countries"; Bird and Gendron (2006) "Is VAT the Best Way to Impose a General Consumption Tax in Developing Countries?"

exemptions, and the extent of taxpayer compliance. Staff's preliminary calculations, using the average C-effciency ratio[4] for high-income countries and applying a rate of 17 percent, suggest that the VAT will yield slightly less revenues than the *monofase*. This highlights the importance of implementing a broad-based VAT with few exemptions, and the need for adequate administrative capacity in the Tax Office. A further reason for not relying on the VAT to meet current consolidation needs is that the VAT system will take time to implement fully, and revenues may be lower than expected initially.

Containing Expenditure Growth

12. Efforts to contain the public sector wage bill should continue. A wage freeze and 10 percent reduction in compensation are in effect in 2011-12. Over the long term, the authorities aim to better align public and private sector wages, by reducing new public sector employees' salaries by 10 percent.



Sources: UPECEDS; and IMF staff calculations.

13. A public administration reform should yield important savings over the medium term. Various laws approving a reorganization of the public administration have been passed by Parliament in recent years, although most have yet to be implemented. Savings are expected to be realized from a downsizing of the public administration through natural attrition—a 4 percent reduction in public administration employment is planned over three years. The government does not expect this to have a significant impact on service provision. Furthermore, the government intends to outsource a number of activities, which should result in a further reduction in the size of the public sector.

14. In conclusion, the authorities' reform plans go in the right direction but implementation will be key. Thus far, reforms have focused mainly on the expenditure side, with revenue measures being of the ad hoc variety. Staff welcomes the authorities' tax reform, although more could be done to raise the effective rate of PIT. The authorities also need to explore ways of raising indirect tax revenues, beyond the introduction of a VAT. Finally, the full and timely implementation of the public administration reforms is encouraged, including efforts to contain the growth of the public sector wage bill.

Summary of Projected Annual Savings From Consolidation Measures by 2017

	Millions of euros	Percent of GDP
Authorities' proposals		
Tax reform	12	0.8
Public administration reform	5.6	0.3
Total	*17.6*	*1.1*
Staff's proposals		
Increase effective rate of PIT to 9 percent	25	1.5
Increase indirect tax revenue by 10 percent	13.7	0.8
Contain wage growth at 1.1 percent per year	3.2	0.2
Total	*41.9*	*2.5*

Sources: Sammarinese authorities; and IMF staff calculations and estimates.

[4] The C-efficiency ratio is the ratio of revenue collected *(VATrev)* to the product of the standard VAT rate *(SR)* and consumption *(C)*, i.e. C(efficiency) = *VATrev/SR*C.*

Box IV.1. Key elements of the authorities' proposed fiscal reforms

Tax reform (under consideration)

- A reduction in existing tax allowances and credits applied to the PIT, to be replaced by a system which would incentivize spending within San Marino.
- A simplification of the income tax regime, including the elimination of joint filing and bringing the self-employed workers and sole proprietors under the same tax regime as employees. Improved controls and requirements for deductions to be supported with the relevant documentation.
- A flattening of the rate structure, including a reduction in the top marginal rate from 50 percent to 35 percent, and a reduction in the number of tax brackets.
- Maintenance of the corporate tax rate at a competitive rate of 17 percent, with a somewhat lower rate for larger companies that meet certain conditions.
- Introduction of taxation (at a low rate) on dividends, capital gains, and foreign income.

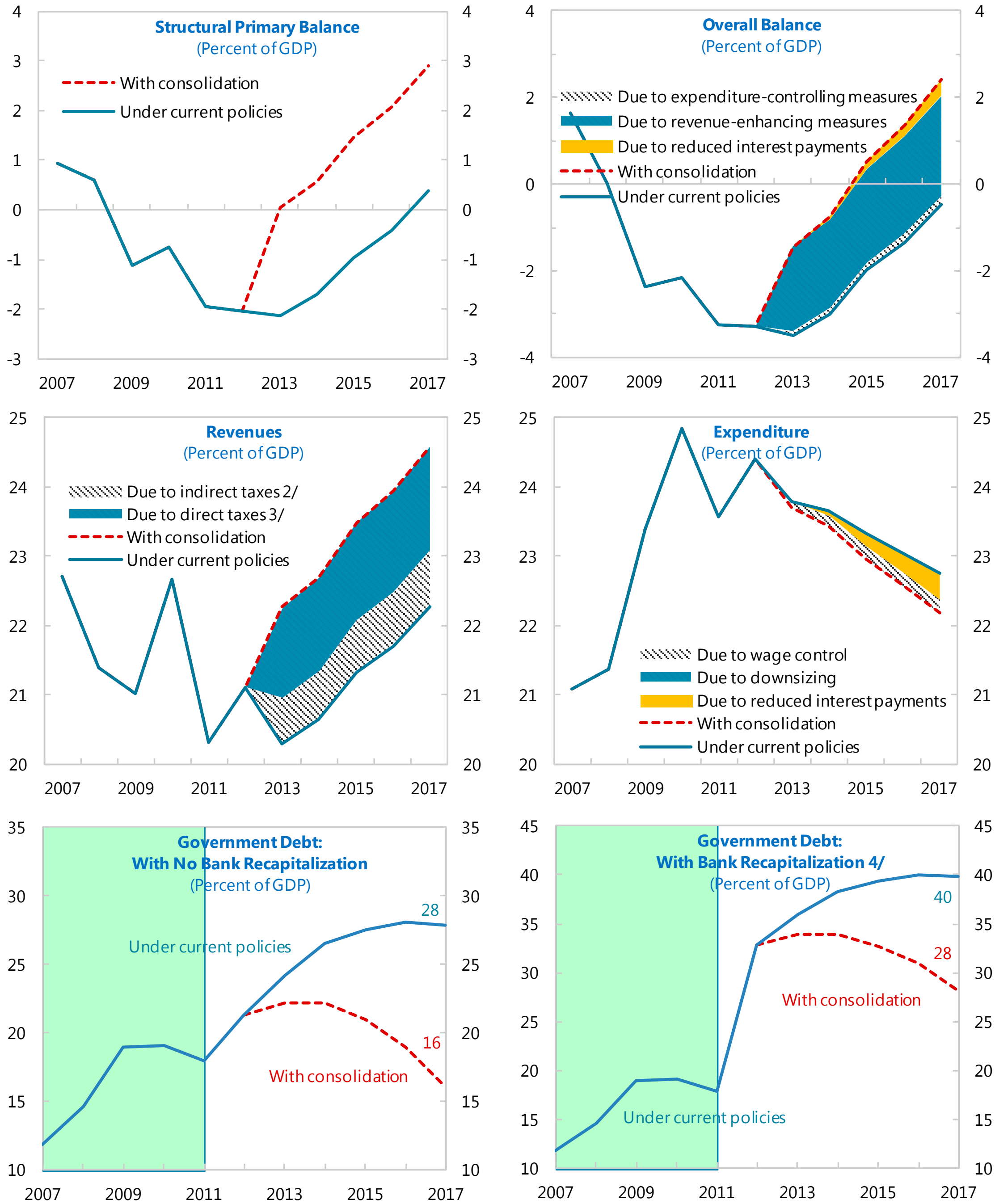
Public administration reform (approved)

- Organizational restructuring, including a reduction in the number of offices.
- Streamlining bureaucratic procedures and improving the public administration's efficiency, through increased accountability of managers.
- A reduction of 240 posts through the outsourcing of certain activities, and 100 posts through natural attrition.
- A 10 percent structural wage reduction applied to new public sector employees.

Pension reform (approved)

- A fully-funded second pillar system introduced in 2012.
- Reforms on the first pillar system include increasing contribution rates, lowering replacement rates, raising the retirement age, and combining various self-employed workers' pension funds into one.

Figure IV.1. San Marino: Fiscal Consolidation Plan Recommended by Staff, 2007-17 1/



Sources: Sammarinese authorities; UPECEDS; and IMF staff calculations, estimates and projections.
1/ For the budgetary central government.
2/ Broadening the application of indirect taxes such as introducing a valued added tax (VAT) or levying a tax on domestically-produced services.
3/ Increasing the effective tax rate on personal income by eliminating tax exemptions.
4/ Assume that 100 percent of bank recapitalization needs indicated by stress tests are financed by the government (net of €20 million committed by CRSM's existing shareholders).

ANNEX V. FUND'S TECHNICAL ASSISTANCE ON NATIONAL ACCOUNTS STATISTICS[1]

1. **A 2011 STA TA mission indicated the need to revise NA statistics.** The September 2011 STA mission found that the current compilation system of NA statistics, which is an income-based approach, does not fully meet international standards. The authorities agreed to revise the NA statistics for 2005–09 by adopting proper expenditure- and production-based approaches. The recently produced preliminary expenditure-based NA statistics for 2007–10 show that the nominal GDP number is about 40 percent higher (in 2009, new number of €1.6 billion vs. old number of €1.1 billion). However, the change in real GDP of the new statistics during 2008–10 is broadly in line with that of the old statistics. In addition, the mission pointed out a key challenge for implementing the expenditure-based approach, due to the lack of BoP statistics, and developed with the authorities an action plan for improving the NA statistics, including by developing more appropriate methods for deriving the volume measures of GDP as well as the estimates of quarterly GDP.

2. **The STA mission also emphasized the need to scale up the capacity of the statistical office, with further TA from STA likely being required.** It was the mission's view that no further improvement in the NA and other statistics could be expected with the current capacity of the statistical office. The mission suggested a new organizational structure, with increased staff capacity. The mission indicated that further TA from STA will likely be required. During the mission it was agreed that a follow-up TA mission on NA statistics would be needed to complete the revision of the NA statistics. In addition, TA in the area of BoP and price statistics, which serve as important inputs in the compilation of NA statistics, will also be needed. Finally, staff from the statistical office will also benefit from attending training courses administered by the Fund.

[1] Prepared by Phakawa Jeasakul

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

April 11 2012

Prepared By

European Department
(In Consultation with Other Departments)

CONTENTS

FUND RELATIONS

(As of March 27, 2012)

Membership Status

Joined: September 23, 1992; Article VIII

General Resources Account

	SDR Million	Percent Quota
Quota	22.40	100.00
Fund holdings of currency	16.95	75.66
Reserves tranche position	5.45	24.34
Lending to the Fund		
New arrangements to borrow		

SDR Department

	SDR Million	Percent Allocation
Net cumulative allocations	15.53	69.35
Holdings	15.37	68.61

Outstanding Purchases and Loans

None

Latest Financial Arrangements

None

Projected Payments to the Fund

None

Implementation of HIPC Initiative

Not applicable

Implementation of Multilateral Debt Relief Initiative

Not applicable

Implementation of Post-Catastrophe Debt Relief

Not applicable

Exchange Arrangements

Prior to 1999 the currency of San Marino was the Italian lira. Since January 1, 1999, San Marino uses the euro as its official currency. The central monetary institution is the Central Bank of San Marino (CBSM). Foreign exchange transactions are conducted through commercial banks without restriction at rates quoted in Italian markets. There are no taxes or subsidies on purchases or sales of foreign exchange. San Marino's exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).[1]

Article IV Consultation

San Marino is on a 12 months cycle. The previous Article IV consultation took place during January 4–14, 2011, and concluded on March 14, 2011 (Country Report No. 11/78).

FSAP Participation

A review under the Financial Sector Assessment Program (FSAP) was completed in 2010.

Technical Assistance

Year	Department/Purpose
1997	STA Multi-sector assistance
2004	STA Monetary and financial statistics
2005	MFD Deposit insurance
2008	STA GDDS metadata development
2009	LEG AML/CFT
2011	STA National accounts statistics
2012	STA Government finance statistics

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.

STATISTICAL ISSUES

(As of March 27, 2012)

Data Provision

Progress has been made since San Marino's participation in the IMF's General Data Dissemination System (GDDS) on May 16, 2008 but important weaknesses in the statistical database remain mainly due to resource constraints. In January 2007, in view of their intention to participate in the GDDS, the authorities named two national GDDS coordinators and announced their objective to increase the frequency of website updates in order to improve data dissemination. As of March 2012, 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 data are compiled annually based on the income approach with about ten months delay. The authorities have also calculated sectoral contribution. However, as part of ongoing STA technical assistance on national accounts statistics, the production and expenditure approaches are adopted instead. Consumer prices and employment data are available monthly with short delay. An industrial production index based on electricity consumption, launched in 2000, became available monthly in 2009. 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 2004-11, as well as the budget for 2012-14. However, the data have not been compiled in accordance with IMF standards. 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 expenditures while "borrowing requirement" is included among the revenues.

Monetary and Financial Statistics

Since 1997, the authorities have provided balance sheet data on the commercial banks and the monetary authorities to STA 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. Data on non-bank financial intermediaries are also lacking.

External Sector Statistics

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 March 27, 2012)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[5]
Exchange Rates	3/26/12	3/27/12	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Q4 2011	Feb 2012	Q	Q	Q
Reserve/Base Money	Q2 2011	Oct 2011	Q	Q	Q
Broad Money	Q2 2011	Oct 2011	Q	Q	Q
Central Bank Balance Sheet	Q4 2011	Feb 2012	Q	Q	Q
Consolidated Balance Sheet of the Banking System	Q4 2011	Feb 2012	Q	Q	Q
Interest Rates[2]	Q2 2011	Oct 2011	Q	Q	Q
Consumer Price Index	Jan 2012	Mar 2012	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2009	Feb 2012	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2011	Feb 2012	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	2011	Feb 2012	A	A	A
External Current Account Balance	NA [6]				
Exports and Imports of Goods and Services	2010	Dec 2011	A	A	A
GDP/GNP	2010	Dec 2011	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 balance of payments data and lack the capacity to provide this information to the Fund.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 12/46
FOR IMMEDIATE RELEASE
May 8, 2012

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

IMF Executive Board Concludes 2012 Article IV Consultation with the Republic of San Marino

On April 27, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of San Marino.[1]

Background

After four years of GDP contraction, largely manifested in a sharp fall in exports and investment, the economy remains fragile, with recent activity indicators pointing to limited signs of recovery. Rising unemployment, stagnant wage growth, and lower confidence have all contributed to falling private consumption and low inflation. Real GDP is estimated to have declined by 2.6 percent in 2011. The recession is expected to linger this year, in line with output developments in Italy, which accounts for 90 percent of Sammarinese exports.

Financial sector balance sheets continued to compress on the back of steady outflows of deposits, while banks' profitability and capital have weakened significantly, mainly due to rising nonperforming loans. The planned recapitalization of the largest bank, Cassa di Risparmio della Repubblica di San Marino (CRSM) remained elusive, but has gained traction in recent months. Further progress has been made on meeting the Financial Sector Assessment Program's (FSAP) recommendations, including strengthening the supervisory functions and independence of the central bank and lowering barriers to international

[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.

regulatory cooperation, as well as on broader transparency initiatives. The development of a sustainable business model for the financial sector remains a long-term challenge.

The fiscal position has weakened, mainly due to a sizeable decline in tax revenues. Tax receipts, in real terms, are estimated to have fallen by more than 15 percent over the past two years, largely due to the recession and lower revenues from the financial sector. The fiscal deficit is estimated to have widened from about 2 percent of GDP in 2010 to around 3 percent of GDP in 2011.

Executive Board Assessment

Executive Directors considered that growing uncertainty about the external environment and the future role of the Sammarinese financial sector weigh on the near-term outlook, raising the risk of a protracted recession and greater financial sector vulnerability. In this context, normalizing relations with Italy and pursuing the unfinished reform agenda would facilitate fundamental structural changes and strengthen medium-term prospects.

Directors noted the marked declines in financial sector liquidity, asset quality, and profitability. In particular, they urged a prompt recapitalization of the largest bank, with government involvement conditional on a new business model and the participation of existing shareholders. More broadly, Directors underlined that the financial sector needs to adapt to the changed domestic and international environment, including by searching for new areas of competitive advantage.

Directors acknowledged the continued progress made on the recommendations of the 2009 FSAP, particularly in strengthening the central bank's supervisory functions and independence, but considered that more remains to be done. They also commended the steps taken on broader transparency initiatives and looked forward to early action to address remaining deficiencies in the regime to combat money laundering and the financing of terrorism.

Directors welcomed the measures taken to contain the 2012 budget deficit but called for a comprehensive medium-term consolidation plan, given growing fiscal risks. They agreed that permanent measures to increase the revenue base should be the focus of such a plan, with additional savings arising from further public administration reform. Directors also stressed the need for a deficit financing plan, which could involve issuing debt instruments on capital markets.

Directors underscored the importance of restoring competitiveness and developing a sustainable growth model. They agreed that structural impediments to growth need to be eased, including by promoting foreign investment and relaxing obstacles in hiring skilled nonresident workers.

Directors reiterated their concerns about shortcomings in economic statistics which hamper policy design and evaluation. In particular, they encouraged the authorities to produce balance of payments data and devote additional resources to meeting international standards for national accounts and government finance statistics.

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. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with San Marino is also available.

San Marino: Selected Economic and Social Indicators, 2007–13

	2007	2008	2009	2010	2011	Projections 2012	2013
Activity and Prices							
Real GDP (change in percent) 1/	3.5	-3.4	-12.8	-5.2	-2.6	-2.0	0.6
Employment (average; change in percent)	3.2	3.5	-0.3	-0.8	-2.2	…	…
Unemployment rate (average; percent)	3.0	3.1	4.5	4.9	5.5	…	…
Inflation rate (average; percent)	2.5	4.1	2.4	2.6	2.0	…	…
Nominal GDP (millions of euros) 1/	1,756	1,732	1,575	1,492	1,472	1,459	1,488
Output gap (percent)	3.2	-1.5	-4.4	-4.4	-4.4	-3.7	-4.1
Public Finances (percent of GDP) 2/							
Overall balance	1.7	0.2	-2.3	-2.1	-2.9	-3.2	-3.4
Primary balance	1.8	0.4	-2.2	-2.0	-2.8	-3.0	-3.2
Structural primary balance	1.0	0.7	-1.1	-0.7	-1.6	-1.9	-2.0
Government debt	11.8	14.7	18.9	19.1	17.9	21.2	24.2
Loans	3.7	3.8	4.0	3.8	3.3	6.5	9.7
Net account payables	8.1	10.9	14.9	15.3	14.6	14.8	14.5
Government deposits	12.2	15.2	16.3	14.6	10.5	10.6	10.4
Money and Credit							
Bank lending (average; change in percent)	…	14.9	13.0	-9.2	-11.4	…	…
Bank funding (average; change in percent)	…	6.0	-7.8	-30.6	-13.5	…	…
Net foreign assets (percent of GDP)	40.7	31.6	11.0	28.7	47.9	…	…
Commercial banks	15.6	2.3	-23.8	6.2	30.0	…	…
External accounts							
Trade balance of goods (percent of GDP) 3/	23.2	24.5	24.4	27.9	…	…	…
Exports	214	227	208	196	…	…	…
Imports	191	203	183	168	…	…	…
Foreign reserves (millions of U.S. dollars)	648	707	790	613	342	…	…
Social Indicators							
GDP per capita (2010)	62,596	U.S. dollars					
Ratio of GDP per capital of:							
Italy	1.84						
EU-17	1.65						
Population (December 2011)	32,166	persons					
Life expectancy at birth, total (2006)	82.2						
Literacy, adult (2008)	81.6						

Sources: IMF, International Financial Statistics; Sammarinese authorities; World Bank; and IMF staff calculations, estimates and projections.

1/ Based on new preliminary expenditure-based national accounts statistics as part of technical assistance by STA, with the revision for 2005–10 expected to be completed by mid-2012.

2/ For the budgetary central government.

3/ Based on national accounts statistics; including goods and services.

Statement by Arrigo Sadun, Executive Director for the Republic of San Marino and Francesco Spadafora, Senior Advisor to Executive Director
April 27, 2012

The Sammarinese economy is undergoing a fundamental adjustment in the face of the global financial crisis as well as of the global quest for strict compliance with international transparency standards. Between 2008 and 2011, the economy contracted by over 20 percent, mainly due to a significant compression of financial institutions' balance sheets as well as a sharp fall in exports and investment; the manufacturing base declined by 30 percent. The unemployment rate has trended higher from a low of around 2½ percent in mid-2008 to almost 7 percent recently, with increasing claims on the benefits provided by the wage-supplemental system.

The recession is expected to linger through 2012. Under the baseline scenario, staff projects that real GDP will decline by 2 percent this year. Given expected output developments in Italy, which accounts for 90 percent of Sammarinese exports, staff projects a very gradual recovery in 2013, with growth hovering around 1½ percent over the medium term. Key downside risks to the baseline outlook include a deeper-than-expected recession in Italy and rising strain in the financial sector.

Facing serious economic and financial headwinds and structural challenges, the authorities have recognized the need to adjust their economic model and to explore new sources of growth. There has been broad support across the political spectrum for efforts to enhance transparency and comply with international standards, which are viewed as critical for normalizing relations with Italy. In particular, the authorities have amended laws and regulations, and stepped up enforcement to comply with MONEYVAL standards on money laundering and OECD standards on tax transparency. While developing new sources of growth is a key long-term goal, both the authorities and the private sector are hoping for a normalization of relations with Italy to help turn the economy around.

Financial Sector

The Sammarinese authorities concur with the staff's views on the risks to, and vulnerabilities of, the financial sector. As far as the recapitalization plan for the Cassa di Risparmio della Repubblica di San Marino (CRSM) is concerned, the authorities are considering participating in it. They are also working on the appropriate conditionality for their participation with a view to limiting systemic risk from CSRM, while pushing the bank toward developing a prudent business plan. At the same time, they stressed that, at the current stage, there is no completely objective basis to identifying the possible scale of write-downs and the attendant recapitalization needs. In this respect, they concur with staff on the need for a contingency plan.

Progresses have been made in implementing the 2009 FSAP recommendations, with particular regard to clarifying and strengthening the powers of the Central Bank of San Marino (CBSM) to cooperate with foreign supervisors. New regulations on financial companies and the attendant enforcement actions are now in line with the FSAP recommendations. A monetary agreement with the European Union was signed off on last March, and the authorities are committed to meeting the EU directive on banking supervision.

As a result of the efforts toward enhancing transparency, both the OECD's Global Forum on Transparency and Exchange of Information of October 2011, and the MONEYVAL AML/CFT mutual evaluation report of September 2011 pointed out the progresses achieved.

On the structural issues of the financial sector, the Sammarinese authorities are cognizant that the main characteristics of the former bank business model are no longer viable. They stress that many measures have been and are being implemented in order to align banking regulations to international standards, while enhancing cooperation on cross-border bank supervision, strengthening the AML/CFT framework, and reinforcing transparency on tax matters. At the same time, they believe that such measures can only set the stage for the financial sector to resume growth, but it is the private sector that needs to develop a new business model capable of matching the new regulatory and supervisory environment, by investing in the appropriate training and capacity building.

Fiscal Policy

The authorities acknowledge the challenges associated with the deteriorated fiscal position and are determined to consolidate public finances. In the last fiscal budget, a number of consolidation measures have been introduced, including tax increases expected to yield additional revenues of about 1 percent of GDP in 2012. On the expenditure side, the freeze on public sector nominal wages, introduced in 2011, will remain in place this year.

The authorities also intend to make progress with structural fiscal reforms. The authorities plan to introduce a broader tax reform in 2013 aimed at simplifying the current system through the unification of tax rates and the cut of some tax allowances and credits. The possibility of a value-added tax (VAT), to replace the current tax on imports, is also under consideration. The public administration reform already underway will also bring an improved control of public finances, including through a reduction in posts due to outsourcing of activities and natural attrition.

In an effort to enhance long-term fiscal sustainability, the parliament has recently approved two pension reform laws aimed at enhancing the sustainability of the first pillar pension system and at establishing a second pillar system with compulsory participation.

The authorities recognize that financing the fiscal deficit has become a growing challenge, and are considering possible options. Initial contacts with an investment bank and a rating agency have been made to explore access to international capital markets.

Structural and Other Policy Issues

The Sammarinese authorities welcome the staff's assessment of the reforms in the labor and product markets, and agree that some processes are to be simplified. In this regard, the authorities aim to further streamline the business licensing process. The authorities believe that the labor market reforms need to strike a balance between growth and social concerns, taking also into account that the Sammarinese labor market rigidities are less acute than in other European countries.

The authorities intend to promote a better-diversified economy in order to buttress a sustainable growth model. However, they underscored that in order to revitalize the manufacturing sector, normalization of relations with Italy is critical. Finally, the Sammarinese authorities remain committed to devoting additional human capital to further develop macroeconomic statistics and they are interested in continued Fund Technical Assistance.