



REPUBLIC OF SAN MARINO

2013 ARTICLE IV CONSULTATION

May 2013

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 2013 Article IV consultation with the Republic of San Marino, the following documents have been released and are included in this package:

- **Staff Report** for the 2013 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on March 5, 2013, 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 18, 2013. 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 by the IMF.
- **Public Information Notice (PIN)** summarizing the views of the Executive Board as expressed during its May 3, 2013 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for the Republic of San Marino.

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REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION

April 18, 2013

KEY ISSUES

Context: The global financial crisis has put an end to the tax and bank secrecy model around which San Marino built its substantial wealth, bringing about a large outflow of non-resident deposits and a sharp (and ongoing) economic contraction. While San Marino managed to avoid a full blown crisis thanks to buffers accumulated during good times, it is confronting sizable financial and fiscal challenges while trying to reinvent itself on a more open and transparent basis.

Financial Sector: System-wide deposit outflows have abated and liquidity buffers are being rebuilt. However, the largest bank, CRSM, remains undercapitalized. If the State has to shoulder sizable additional recapitalization costs, it should dilute shareholders commensurately and take control of the bank's management and board.

Fiscal Policy: San Marino's inherent vulnerabilities and potentially large contingent liabilities from the banking system call for a rebuilding of fiscal buffers, which will require significant fiscal consolidation over the medium term. In this context, the planned tax reform and expenditure review need to target more ambitious savings.

Structural Issues: The key structural challenge is to develop new growth sectors. Fully normalizing relations with Italy will be an important pre-condition, but replacing lost activities will also require the acquisition of new skills and, outside of banking, a significant improvement in cost competitiveness. Planned labor market reforms should help in this regard.

Previous IMF advice: The authorities have followed Fund advice to recapitalize CRSM, but they did not impose strong conditionality on existing shareholders as had been counseled. In line with past Fund recommendations: (i) measures are planned to strengthen the tax revenue base; (ii) further steps have been taken to improve openness and transparency; and (iii) forthcoming reforms aim to make the labor market more flexible and efficient.

Approved By
**Aasim Husain and
 Peter Allum**

The 2013 Article IV discussions were held in San Marino during February 21–March 5, 2013. The staff comprised Mr. Miniane (Head), Messrs. Lakwijk and Vichyanond (both EUR), and Mr. Parker (MCM). Ms. Marchettini (OED) joined the mission. The mission met with Minister of Finance and Budget Felici, Minister of Foreign and Political Affairs Valentini, Minister of Industry Arzilli, Minister of Labor Belluzzi, Central Bank President Clarizia, other senior officials, members of parliament, private sector representatives, and the trade unions.

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GENERAL CONTEXT

1. The global financial crisis put an end to San Marino's growth model. San Marino had, for many years, built its substantial wealth on the premise of bank and tax secrecy. In the process, it acquired the typical characteristics of small tax havens, notably a very high GDP per capita of some €60,000 and an outsized financial sector, with assets over nine times GDP in 2008. But the global financial crisis put an end to this model, notably via actions taken by Italy:

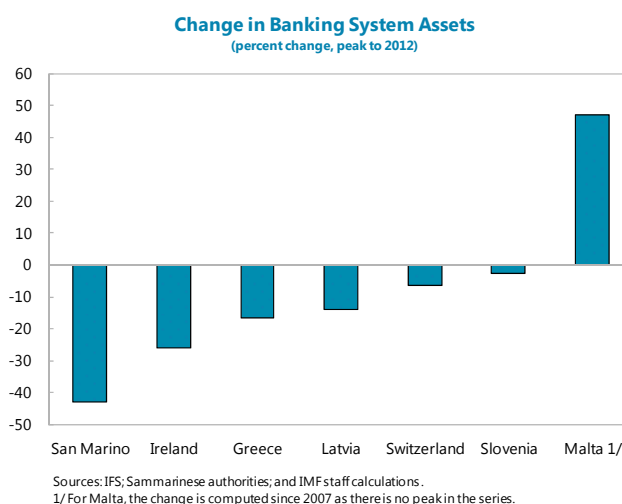
- Italy included San Marino on its tax black list, effectively imposing stringent reporting requirements on Italian companies doing business with San Marino. The Bank of Italy also increased reporting requirements on financial institutions dealing with San Marino.
- In 2009–10, Italy introduced tax amnesties aimed at repatriating capital hidden abroad.

2. These developments, coupled with weak external demand, triggered a deep recession.

Over 2009–11, the banking system experienced a 60 percent decline in non-resident bank deposits, while resident deposits stayed stable. In turn, fiduciary companies serving non-residents lost much of their business. Assets under their management fell from more than €3.5 billion at end 2008 to less than €500 million now, not least because of efforts made by the Sammarinese authorities to make the system more transparent. The balance sheet

compression in the financial sector has significantly exceeded that of other countries undergoing deleveraging. Outside of banking, the manufacturing sector, already coping with low demand from abroad, began to cave under the *de facto* isolation imposed by Italy's black list. These combined shocks led to a deep economic contraction, with GDP falling by a cumulative 28 percent since 2007.

3. Adding to these problems, the largest bank made serious losses on its investments abroad. Cassa di Risparmio della Repubblica di San Marino (CRSM), whose assets accounted for 37 percent of total system assets and for 240 percent of GDP in 2008, bought into the Italian Delta group about a decade ago, and subsequently extended loans to Delta and its affiliates both directly and through complex arrangements involving third parties. In 2009, Delta was intervened by the Italian authorities due to unauthorized activities carried out by CRSM in Italy via Delta, and then placed under a debt restructuring plan. The full extent of CRSM's losses is yet to be ascertained, as the Delta special administrator only reached agreement with the bank's many creditors in December. But, as discussed below, the losses have left CRSM severely undercapitalized even in an



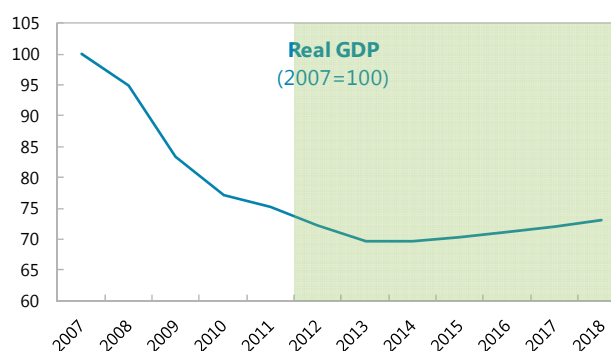
optimistic loss scenario. CRSM also had to be lent over €300 million in emergency liquidity support by the central bank and other Sammarinese banks in 2010.

4. Despite these massive shocks, San Marino managed to avoid a crisis thanks to the buffers built during good times. CRSM's involvement in Delta notwithstanding, Sammarinese banks had prudently invested their non-resident deposits in relatively safe and liquid Italian securities. This allowed them to meet the large deposit outflows despite the central bank's limited lender-of-last-resort capabilities.¹ The central bank also played a key role in preserving financial stability, notably by quickly and effectively intervening some small institutions in difficulty. On the fiscal front, the country's long history of budget surpluses meant that the large decline in tax revenues only translated into relatively modest deficits (about 3 percent of GDP in 2012); also, San Marino had accumulated some 15 percent of GDP in fiscal reserves before the crisis, which allowed the country to finance these deficits without borrowing much.

5. Recent indicators suggest the economy continues to contract. GDP is expected to have fallen by 4 percent in 2012, with the decline led by tourism, banking, and construction. Manufacturing activity fared a bit better, though it still contracted by about 1–2 percent. The unemployment rate is now at 8.1 percent versus 6.8 percent at end 2011, but this understates the sharp decline in employment over the last year notably among qualified non-residents, with the largest declines in financial services (-7.1 percent) and manufacturing (-3.8 percent). Staff expect a GDP decline of similar magnitude (3½ percent) for 2013. This is because external demand, including tourism, will be weak as long as Italy remains in recession, while more Sammarinese businesses will face difficulties as a result of the black list.

6. Risks to the short-term outlook are clearly on the downside (see Appendix I). San Marino's economy would suffer if financial turbulence were to again grip the eurozone, notably via lower demand for Sammarinese products and lower tourism revenues. This would be particularly true if financial market pressures were acute in Italy. Looking at domestic risks, prompt and effective recapitalization of CRSM (see below) will be important to preserve confidence in the financial system.

7. The medium-term outlook is very uncertain, as San Marino is in search of new growth engines. There is a recognition across all key stakeholders that San Marino needs to turn the page on its past, embracing greater transparency and openness. There have been, in fact, good strides made in this regard. But what will be the country's comparative advantage in the absence of tax and bank secrecy? This remains very much an



Sources: Sammarinese authorities; and IMF staff calculations .

¹ San Marino is fully euroized, but it is not a member of the EU or by extension the eurozone. As such, it is not allowed to print euros, except in small mint batches.

open question, related to which is the viable size of the banking sector (see section C). The timing of full normalization of relations with Italy, a necessary but not sufficient condition for robust growth, represents an additional unknown. In this context, significant two-sided uncertainty surrounds staff forecasts of 1–1½ percent medium-term growth. Regardless, much of the 30 percent GDP loss in recent years appears to be permanent, largely representing activities related to tax and bank secrecy which are unlikely to return.

POLICY DISCUSSIONS

A. Financial Sector

CRSM

8. The process of CRSM recapitalization is ongoing. Over the last year, the bank's shareholders—a charitable foundation with roots dating to the 19th century—contributed €20 million of new equity capital by converting deposits they had at the bank, and obtained €60 million via a loan from the government which they proceeded to inject as their own capital. More recently, the bank issued €40 million in subordinated debt to institutional investors, €35 million of which were subscribed by the (public) social security fund, which converted deposits to finance the operation.

9. The State has contributed most of the recapitalization funds so far, but without diluting existing shareholders. Given the bank's systemic importance within the financial system and the economy at large, and considering the shareholders' limited means, it was crucial that the State step in to recapitalize the bank. However, staff observed that the modalities followed have not respected best practice. The government has directly or indirectly contributed €95 million out of the €120 million in recapitalization funds so far, yet existing shareholders have not been diluted at all, and they retain majority control of the bank's board of directors. As things stand, shareholders have full claim to any potential future profit, but the State has assumed most of the downside risk of the operation. The current governance also does not provide strong incentives for a proper restructuring of the bank, so as to return it to profitability expeditiously.

10. Despite the recent injections, more capital will be needed. The full extent of CRSM's losses on its Delta investment is yet to be ascertained. The bank has so far written off some €600 million in equity and loan losses related to Delta, but more is expected. Following the agreement reached between the Delta special commissioner and Delta's creditors in December, CRSM should start receiving in May the remaining assets currently immobilized in Italy. It is only then that CRSM will be able to assess the full extent of losses. Still, loss estimates prepared by CRSM's auditors and the Delta special commissioner—the latter with direct knowledge of the underlying assets—indicate that the bank will require additional capital in order to comply with minimum prudential requirements. Early recapitalization would help safeguard financial stability and support confidence and overall economic prospects.

11. The State should stand ready to provide this additional capital. Ideally, the additional capital would be provided by reputable private investors, but this looks unlikely at this stage: the existing shareholders have provided very little fresh capital so far, while other private investors would likely be deterred because of uncertainty over the scale of the losses. Other avenues currently being considered to recapitalize the bank have important shortcomings: (i) a recent law allowing banks to claim tax credits for past losses carried forward, while reasonable on principle, would not provide CRSM with real capital at a time when the bank is not making any profits and hence not paying any taxes; (ii) plans to issue subordinated debt to retail investors would not be desirable, as they could make the State the ultimate bearer of risk without giving it a claim on the upside risk. Given these considerations, the State will likely need to assume the brunt of future recapitalization, but staff advised that it do so imposing stronger conditionality than in the past. In particular, the State should obtain a share in the bank's equity commensurate to its participation in the recapitalization; it should also nominate the bank's top management as well as a majority of executive board directors, given that it will have contributed the bulk of the recapitalization funds. Legal provisions that protect the foundation's majority stake in the bank should be overturned.

12. The State has the fiscal space to take on the recapitalization. This is because debt is currently low at 20 percent of GDP, although it could rise to 40 percent over the medium term excluding recapitalization costs unless fiscal consolidation is enacted. Moreover, staff proposed that part or all of the recapitalization could happen via a government bond directly subscribed by CRSM in exchange for common equity, obviating the need to actually borrow the funds. Given that San Marino lacks bonds that can be used as a benchmark or a market to trade government securities, recapitalization via bond issuance to the bank would have to pay close attention to the following parameters: (i) setting the right interest rate, ideally mimicking the current cost of funding of the banks; (ii) setting the right maturity, to avoid immobilizing a large part of CRSM's balance sheet with a security that cannot be redeemed for a long period; (iii) and deciding whether this bond can be repoed at the central bank, should CRSM need liquidity.

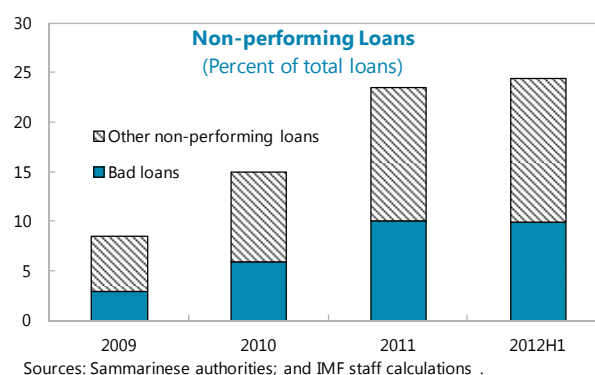
13. Design and implementation of a comprehensive restructuring plan will be needed to return CRSM to profitability. As it stands, the current restructuring plan consists mostly of a set of cash flow and balance sheet projections for a variety of scenarios. In addition to these projections, staff noted that the plan needs to lay out in detail the operational measures that will be undertaken to turn CRSM around, based on realistic assumptions about what can and cannot be implemented given available resources. Proper benchmarking of the bank with relevant competitors should also be part of the plan. It is imperative to return CRSM to profitability expeditiously, for the ultimate goal of any State investment in the bank should be to resell the restructured operation to the private sector within a reasonable period of time.

14. The authorities agreed that the bank needs more capital, and emphasized that all efforts will continue to be made to preserve CRSM, protect its depositors, and return the bank to profitability expeditiously. They stated that any estimate of losses is speculative at this stage, given that only the Delta commissioner has detailed knowledge of the assets. Still, they acknowledged that, under realistic assumptions, the bank will need more capital which they stand

ready to provide, aided by the low level of public debt. They will consider the possibility of recapitalizing the bank via direct issuance of bonds, emphasizing the importance of a market based approach when setting the bond's parameters. Regarding the modalities of the recapitalization, the authorities acknowledged that while the steps they have taken so far may not have been fully in line with best practice, their priority was to preserve confidence, which has been achieved. Going forward, they concurred that legal provisions protecting the foundation's majority stake should be removed, and will consider the possibility of diluting existing shareholders as well as taking control of the bank's management and board. Finally, the authorities have requested that the bank shore up its restructuring plan, so that it maps out in detail the operational changes to be taken to return the bank to profitability.

Asset Quality

15. The recession is leading to mounting non-performing loans (NPLs) across all banks. The ratio of gross bad loans to gross total loans, which was below 3 percent in 2009, is now about 10 percent; using a wider definition that also includes problem loans, restructured loans, and past due and overdue loans, the NPL ratio is close to 25 percent. While NPLs have increased within every sector of economic activity, the construction sector is particularly affected.



Sources: Sammarinese authorities; and IMF staff calculations .

The severe correction in residential and commercial real estate is also causing losses in some non-bank financial firms. Assets in these firms are only slightly more than 10 percent of financial system assets, but they still account for more than 50 percent of GDP.

16. Low profitability could hamper provisioning against losses. Profits before provisions were about €20 million in the first half of 2012 (no full 2012 data yet), compared with some €60 million in the first half of 2010 and €165 million in (full year) 2007. The provisioning ratio currently stands at some 52 percent for bad loans, and 33 percent for the wider definition of NPLs. It should be noted that, in San Marino, banks provision on the basis of *expected* losses. Furthermore, there are no prudential requirements on provisioning, just indicative guidelines, supported by conservative definitions of expected losses on the basis of which banks are expected to provision.

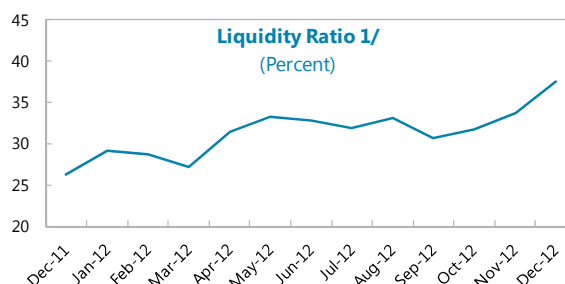
17. Outside of CRSM banks have respectable capital buffers to absorb losses, but recapitalization needs in these banks cannot be excluded. According to stress tests performed by staff, the banking system ex. CRSM has enough buffers to absorb a 5–7 percentage points further increase in the NPL ratio while still complying with prudential capital requirements. Beyond that, capital needs would materialize, but they would remain manageable as long as the increase in the NPL ratio relative to current values does not exceed ten percentage points. This would be quite an extreme jump, but one that cannot be excluded in the current recessionary context. Supervisors welcomed staff's assessment that capital buffers outside of CRSM should be sufficient in all but tail scenarios, an assessment which is in line with theirs.

18. The central bank is taking appropriate action to preserve financial stability. It has commendably started an intensified regime of on and off-site supervision to ensure that banks and non-bank financial entities are provisioning adequately against losses, as well as to detect budding problems as early as possible. In addition, staff noted that the central bank has, by and large, effective tools to take remedial action where needed, as their actions to resolve banks in the past demonstrated. Still, while the banking law is generally effective, it can be improved upon by establishing the central bank as the sole resolution authority and implementing a special bank resolution regime, as opposed to resolving banks via the corporate insolvency law. At present, the banking law does set forth special rules for bank insolvency, but the provisions of the bankruptcy law continue to apply insofar as they are compatible with respect to matters not expressly provided for in the banking law. At a minimum, bankruptcy court judges should not have the authority to reverse or suspend the decisions of the supervisory/resolution authority, and challenges to the latter's decisions should be limited to monetary compensation. In the face of mounting NPLs, the authorities emphasized that no forbearance will be granted to banks, and that they remain committed to intensive on and off-site supervision for the foreseeable future. Should remedial action be needed, they stated that they will not hesitate to impose it expeditiously as was done in the past.

Liquidity

19. Deposit drains in the banking system have halted, while the Delta resolution is boosting liquidity at CRSM. Banks lost less than €50 million in deposits in 2012, after losing close to €600 million in 2011 and €2.5 billion in 2009–10. The most recent data point to an actual increase in deposits in some banks in the last few months, albeit modest. Regarding CRSM specifically, the Delta resolution is boosting liquidity as more assets that were immobilized in Italy are slowly released to the creditors. This has allowed CRSM to recently repay most of the emergency liquidity support it received in 2010 in amounts exceeding €300 million. CRSM should receive further assets down the road as part of the ongoing resolution, and while they will likely imply significant losses relative to book value, receipt of these currently immobilized assets will allow the bank to generate needed cash flow.

20. Overall, banks' liquidity buffers are comfortable. The stabilization in deposits has given banks breathing room to replenish their liquid assets, which have increased by about 50 percent in the last year. As a result, the coverage of liquid liabilities has improved as well, and is now over 35 percent for the banking system as a whole.² Perhaps more relevant given that resident deposits have proved very stable, the coverage ratio of liquid non-resident deposits is above 100 percent in most banks, and above 50 percent in all the systemic ones. In



Sources: Sammarinese authorities; and IMF staff calculations .
1/ Liquid assets as a share of liquid liabilities, excluding inter-bank loans.

² This excludes inter-bank loans within San Marino.

addition, some banks have arranged contingent credit lines with private counterparties abroad. The banks' own buffers thus appear sufficient to cover all but the most extreme deposit outflow scenario.

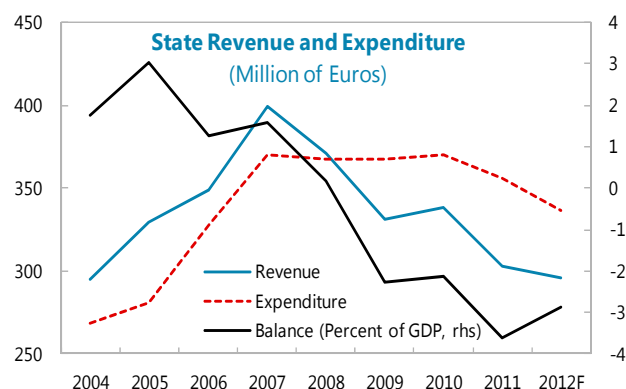
21. These buffers are complemented by those of the central bank and deposit insurance fund. The central bank has recently negotiated a contingent credit line that allows it to repo ECB-acceptable securities for cash with a foreign private counterpart on a three to twelve month maturity. Moreover, a deposit insurance fund has recently been established with coverage of deposits up to €50,000 per account, though the authorities should gradually move from the current ex-post scheme to an ex-ante one, in line with the 2010 proposed EU directive on deposit insurance. In the central bank's view, total buffers in the system are sufficient to cope with any plausible eventuality, as they believe further deposit outflows of the scale seen in 2009 and 2010 are extremely unlikely.

22. Prudential liquidity requirements, now minimal, are set to increase. Currently, the central bank does not impose any prudential liquidity measure other than the standard 8 percent reserve requirement. This is an important gap considering San Marino's lack of a lender of last resort and the large size of the banking system. Going forward, the monetary agreement between San Marino and the European Union contemplates San Marino adopting Basel III core principles by 2016, among which are enhanced liquidity rules, an important element for San Marino. The central bank agreed that these liquidity rules will be an important addition to the prudential toolkit.

B. Public Finances

23. Public finances have deteriorated despite consolidation efforts. On the revenue side, the authorities introduced over 2010-12 a real estate tax, a 15 percent surtax on general income, a minimum tax for corporations/sole proprietors with limited turnover, and a luxury tax. Despite these measures, which have yielded an estimated €25 million (some 2 percent of GDP) in additional revenue,

total central government revenues have fallen by about €100 million since 2007 because of the deep economic contraction. Efforts have also been carried out to contain expenditures. Increases in nominal public sector wages have been kept below inflation, which together with attrition in employment has kept the public wage bill flat in nominal terms. In addition, capital spending has been reduced from €60 million in 2008-09 to €30 million in 2012. As a result of these efforts, total central government spending has fallen by about €30 million since 2007 (after increasing by €70 million during 2004-07). These combined revenue and expenditure efforts have helped limit the deterioration in the state balance, which has moved from a surplus of about 1½–3 percent of GDP



Sources: Sammarinese authorities; and IMF staff calculations .

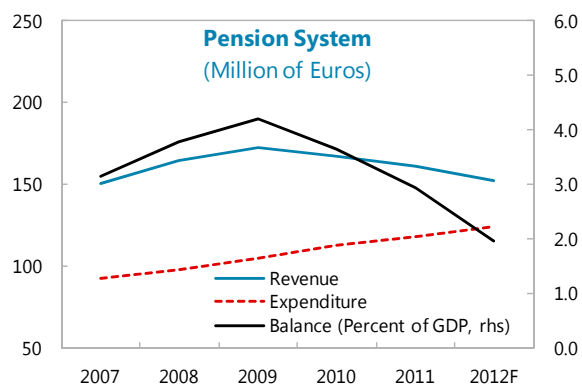
in the years before the crisis to a projected deficit of 2.9 percent in 2012. A new tax on insurance premia should help the deficit stay at this level in 2013 despite the continued economic contraction, a view that is in line with the authorities' own forecasts.

24. Moreover, the crisis has brought into question the sustainability of the pension system.

San Marino embarked on two reforms of the public pension system, a substantial one in 2005 and a more modest one in 2011, intended to ensure the sustainability of the system in the face of population aging. However, the reforms did not contemplate a more than 25 percent decline in GDP. Pension

contributions, which were increasing rapidly post-reform thanks to increases in contributions

rates and the extension in the contributory period, are now falling because of depressed employment and incomes. The decline in contributions is occurring much earlier than demographic trends alone would have suggested. On the other hand, nominal pension outlays continue to increase. The end result is that the balance of the system has fallen from 4½ percent of GDP in 2009 to about 2 percent in 2012, too small a surplus considering that the brunt of population aging is still to be felt. The surplus is also significantly smaller than had been projected at the time of the reform. The authorities concurred with this analysis, but took existing reserves in the pension system as assurance that no budget support will be needed in the short and medium-term.



Sources: Sammarinese authorities; and IMF staff calculations .

25. Significant additional budgetary savings will need to be found over the medium term.

As recent experience shows, San Marino's inherent vulnerabilities as a very small and open economy argue in favor of having ample fiscal buffers. True, public debt is currently low, but it could increase significantly going forward due to bank recapitalization needs. Moreover, with much of the output recently lost unlikely to return, which in turn renders a significant rebound in taxes unlikely, staff project sizeable deficits in the 3—3½ percent of GDP range in the absence of new measures—deficits which would, in turn, add to any increase in debt brought about by recapitalization. Anchoring debt in the context of significant contingent liabilities will thus require additional budgetary savings of about 4—5 percent of GDP costs (see Appendix II—public debt sustainability analysis). The pain of fiscal consolidation in a recessionary context cannot be understated, yet despite the lack of offsetting monetary policy fiscal multipliers are likely small in San Marino, with imports accounting for some 150 percent of GDP.

26. The planned tax reform would provide a great opportunity to find savings. The authorities plan to soon resubmit to parliament a tax reform that was shelved last year (see box 1). In its broad outlines, the tax reform focuses on income taxation, and aims to lower marginal tax rates for both corporate and personal income tax while broadening tax bases. Staff recommended that the authorities seize the opportunity offered by the reform to make the tax system more transparent and less distortive, but also to generate whatever additional revenue is needed.

Box 1. The Planned Tax Reform

The authorities plan to submit to parliament a reform of income taxation that has been under consideration since 2011. The focus of the reform is on income taxation; indirect taxes, in particular the possible introduction of a VAT, is not being contemplated at this stage. A common feature of the changes being proposed for personal and corporate income taxation is the broadening of tax bases through elimination of tax credits and deductions, and the simultaneous lowering of tax rates. The reform also introduces administratively burdensome features, a particularly relevant factor in a micro state with naturally limited administrative capacity. The overall yield of the tax reform as it stands may be around 1.0 percent of GDP. Details of the proposed changes for corporate entities and employees, which are responsible for the bulk of direct tax receipts, follow:¹

- For corporates, tax credits amounting to about 20 percent of gross tax liabilities are to be eliminated, and the tax rate lowered from 17.2 percent to 16 percent. In addition, a minimum tax applied in recent years is to be institutionalized (except for new businesses). It is also proposed that higher-income corporates pay a reduced tax rate of 13 percent if they satisfy particular conditions intended to promote domestic value-added creation—conditions that will need to be verified by the tax office.
- For employees, standard deductions are to be reduced sharply (by nearly 60 percent), but at the same time deductions allowed for individual expenses are to be quadrupled—these are aimed at promoting domestic purchasing, the documentation for which will need to be checked by the tax office. These two elements balance each other out, leaving the taxable income of employees little changed. In addition, the plan contemplates a sharp reduction in the average tax rate from 16.8 percent to 7 percent, compensated by the virtual elimination of tax credits (which currently amount to a substantial 9 percent of gross income). Finally, taxable income will now be defined on a worldwide basis.

¹ See also “Republic of San Marino—Staff Report for the 2012 Article IV Consultation.”

27. The planned tax reform follows good principles, but it does not generate sufficient additional savings. Lower nominal rates coupled with the elimination of deductions and tax credits should make the tax system less distortive, although verification costs are set to increase. Moreover, preliminary estimates suggest that base broadening will more than compensate for the lower rates. The problem is that the projected revenue gains from the reform are modest at 1 percent of GDP—assuming all elements of the plan pass through parliament—which is not enough if San Marino is to find 4–5 percent of GDP in budgetary savings over the next few years balanced across revenues and expenditures. There is room to increase *effective* personal income tax rates further,

which at 6 percent post reform will remain very low by international standards. For efficiency reasons, the first step should be to reconsider the introduction of new deductions, particularly those that impose significant verification costs, but the reduction in marginal tax rates could be made less drastic as well. The tax reform should also make permanent the real estate tax, which is set to expire in 2013. Real estate taxes are a good source of revenue, in that they are relatively undistortive and can be made quite progressive and fair.

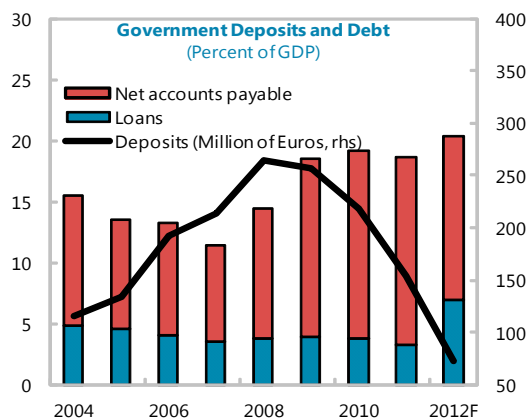
28. Similarly, the upcoming expenditure review will need to consider cuts in the big expenditure items, namely public wages and social benefits. The government intends the expenditure review to be broad enough to encompass all categories of public spending, including bank recapitalization. As commendable as this is, the review should start from the premise that the spending envelope needs to be reduced further, as recent efforts have not been sufficient. Despite limits on nominal wage increases and the imposition of attrition, the public sector wage bill is still two percentage points of GDP higher than it was before the crisis. Similarly, efforts to contain health expenditures—via the repatriation of medical services from Italy to San Marino, the purchase of medical drugs directly from manufacturers, and limits on which doctors are allowed to prescribe highly costly drugs,—have not prevented these expenditures from increasing by 2 percentage points of GDP as well. And, as discussed previously, the sustainability of the pension system is in doubt. Nevertheless, while cuts appear unavoidable in order to put public finances back on a sound footing, the government should ensure that any cuts be made in a progressive fashion, so as to spare the most vulnerable in society.

29. The authorities concurred with the need to consolidate, but warned that this will not be easy in the current context. They emphasized the crucial role that pre-crisis fiscal surpluses and large fiscal reserves had played in avoiding a crisis, and agreed with the need to rebuild fiscal buffers in light of contingent liabilities. On this, they noted that the 2012 budget law includes a target of a balanced budget by 2014. Although they acknowledged that this will be hard to achieve on the basis of current and planned measures, they saw value in maintaining the target to manage expectations. This being said, the authorities cautioned against the difficulty of increasing taxes and cutting expenditure in a recessionary context, and worried that there might not be enough political consensus to do so. They also warned that revising the parameters of the tax reform would require renewed consultations with social partners. Finally, the authorities saw little scope for a third pension reform in less than ten years.

30. Financing pressures should be manageable for now.

Budget deficits in recent years, as well as the ongoing CRSM recapitalization, have been financed mostly via drawdown of accumulated deposits. These have now fallen to a low €72 million (5 percent of GDP), from about €270 million before the crisis. Given that, by law, deposits are not allowed to dip below €45 million, the government will need to borrow in the future to finance its needs. Still, there is sufficient liquidity in the banking system to finance the state deficits for now, and bank recapitalization can be implemented via bond

issuance that does not require actual borrowing. This being said, it would be prudent to diversify financing sources going forward, and to start exploring such possibilities soon given San Marino's almost non-existent borrowing history and hence the need to build borrowing relationships from scratch. The authorities agreed that there is enough liquidity in the domestic banking system as long as financing needs are not excessive. They said they prefer this option to borrowing abroad given the high costs of the latter for a small economy like San Marino.



Sources: Sammarinese authorities and IMF staff calculations

C. Structural Issues

31. The key structural challenge facing San Marino is to develop new growth sectors that make up for the loss of the traditional economic model.

Some stakeholders in the financial industry see a future centered on asset management, an activity that in principle carries fewer risks to the sovereign than traditional banking. However, positioning San Marino as an asset management hub will take time and considerable resources as the needed expertise is not fully developed yet, and nor is the legal, administrative, or IT infrastructure.³ Extending traditional banking activities to surrounding regions and even further afield is also being considered, in which case it will be important to ensure that cross-border banking activities do not overstretch the country's supervisory capacity, and that balance sheets do not grow unduly from their already high levels. Outside of banking, the country enjoys a long standing manufacturing tradition, with the sector presently accounting for a third of GDP and about 25 percent of total employment. Still, for manufacturing to pick up the slack of lost banking activities would require improved cost competitiveness.

32. A necessary but not sufficient condition for robust growth will be to normalize relations with other countries, notably Italy. Sammarinese companies, be they financial or not, need a level playing field if they are to survive and compete. To achieve this goal, San Marino needs

³ See Selected Issues Papers of the 2010 Article IV Consultation, and the White Book recently prepared by the Association of Sammarinese Banks.

to continue shedding the legacy of its past as a tax haven, something that the authorities are committed to doing.

33. San Marino has made important progress towards openness and transparency.

International, peer-reviewed assessments have confirmed this progress: for instance, the latest MONEYVAL assessment on AML/CFT issues in 2011 indicates significant improvements in formal compliance with the FATF standards. Exchange of information with other jurisdictions on tax and money laundering matters has also been stepped up, with the legislative framework now giving the Sammarinese authorities greater powers to collect and transmit information. Not only are banks subjected to tighter controls by the authorities, but many leasing and fiduciary companies that provided a vehicle for non-residents to evade taxes have been shut down. This being said, progress is still needed in some areas, which include extending and implementing effective due diligence to legacy customers, criminalizing self-laundering, making all serious tax crimes predicate offense to money laundering, and ensuring operational independence of the AML supervisor.

34. New bilateral and multilateral agreements should help entrench this progress. In particular, San Marino has ratified three key bilateral agreements with Italy, the double taxation, financial cooperation, and economic cooperation agreements (see box 2). These agreements now await ratification by the Italian parliament. Among other things, the treaties will define the principles and modalities for the exchange of tax information, and for supervisory cooperation between the two central banks on cross-border banking activities. Other initiatives, such as the Monetary Agreement between the European Union and San Marino which entered in force in September 2012, also point to a desire to engage and integrate more fully with the international community.

35. Despite progress on the ground, normalizing relations with the international community will take time. After the Monti cabinet approved the double taxation treaty in December, many had hoped for a prompt ratification of the treaty in the Italian parliament. This would, in turn, pave the way for the ratification of the other two agreements, and facilitate the eventual removal of San Marino from Italy's tax black list. However, the political situation in Italy has now significantly delayed this process, and it remains unclear at this stage when ratification might happen. Beyond these setbacks, which are unrelated to actions or lack thereof on San Marino's part, the process of regaining the trust of the international community will likely be gradual.

36. San Marino also needs to improve its cost competitiveness. While recent wage data are not available, recent labor agreements point to nominal wage growth in the range of 0–1½ percent, representing only a small decline in real terms. In fact, the cumulative decline in real wages so far has been modest considering the depth of the GDP fall, with much of the adjustment happening via quantities. This decline may be enough to keep wage differentials with Italy manageable, but it is not enough of a competitiveness boost for new sectors to make up for the loss of traditional economic activities. This loss is akin, *de facto*, to a significant appreciation of the real exchange rate, one which will not be easy to absorb in the context of a fixed exchange rate.

37. Labor market reforms being put in place should help facilitate this process. The government is planning to replace the 1961 labor code this year, building on recent reforms that

decentralized the employment system. Specifically, firms will no longer be obliged to hire their workers from the state's employment list, and employment procedures have been simplified for cross-border workers especially in sectors or professions in which skilled resident workers are scarce. Finally, a voucher system will be put in place to allow firms to easily trade employee working days, and hiring through apprenticeships will be institutionalized. An important measure that remains to be considered is the reduction in the number of national holidays, which is high hence negatively impacting Sammarinese productivity. Of note, procedures for firing workers are not particularly cumbersome or costly.

Box 2. International Cooperation Agreements

Three key bilateral agreements with Italy in the economic and financial spheres are pending:

- *A double taxation agreement (DTA)*. Other than avoiding the double taxation of nationals, a key goal of the agreement is the prevention of tax fraud. The agreement is comprehensive and follows best OECD practice. Of note, San Marino already has in place more than thirty bilateral DTAs.
- *Financial cooperation agreement*. The aim of the agreement is to promote the development and integration of the respective financial systems. Cross-border supervisory cooperation is an important component of the agreement, with emphasis on cooperation without any confidentiality constraints. As part of the agreement, San Marino commits to continue to transpose best international standards into its law on such matters as AML/CFT.
- *Economic cooperation agreement*, focused on the promotion of economic activities of value to both countries, including the development of cargo infrastructure within the Rimini airport, a science and technology park, and joint tourism ventures.

The agreements need to be ratified by both parliaments. San Marino has already ratified the three treaties, and they now await ratification in the Italian parliament (the double taxation treaty was approved by the Monti cabinet last year and sent to parliament). By design, entry into force of the treaties will be sequential, in the order listed above.

Separately, San Marino signed a new monetary agreement with the European Union (EU) in March 2012 that allows it to continue to use the euro as its official currency. On its part, San Marino commits to transpose into its law within four years EU requirements in the fields of banking and financial supervision (including Basel III core principles) as well as the prevention of money laundering.

Finally, San Marino is at present pursuing bilateral DTAs with five additional countries, and is negotiating memoranda of understanding for cross-border supervisory cooperation with two jurisdictions.

38. The authorities reiterated their commitment to shedding the legacy of bank and tax secrecy. They view continued inclusion in Italy's tax black list as the main obstacle to growth, and believe San Marino has done enough progress in the areas of tax fraud avoidance and the exchange of tax information to merit removal from the list. In addition, the authorities hope that the three major bilateral treaties will soon be ratified by the Italian parliament. At the same time, they stated that the current state of affairs should not mask the very strong and growing cooperation between the two countries in many areas. The authorities are also keen to build bridges with countries beyond Italy, as they see economic diversification as key for the future of the economy. In order to support growth, the authorities emphasized their efforts on several strategic projects, including a science and technology park and the development of the Rimini airport as a regional cargo hub, both joint with Italy.

D. Data Issues

39. There are some data gaps which are not uncommon for a small country like San Marino. In particular, national account and fiscal statistics lack the detail required by international standards, and are produced with significant delay. Balance of payments data are not currently available, but the challenges of producing such data for a micro state with fully open borders cannot be underestimated. San Marino is set to receive Fund technical assistance on BOP data, just as it received technical assistance on national accounts, fiscal, and monetary and financial statistics in the past. Of note, banking sector data are quite comprehensive, a key consideration given the importance of the sector within the economy. On balance, the data are of sufficient quality for surveillance purposes.

E. Staff Appraisal

40. The economic situation remains very challenging. Staff forecast an economic contraction of 3 percent for this year, after an estimated 4 percent GDP decline in 2012. This is because of the weak economic outlook for Italy and other European countries, and the impact on Sammarinese businesses of the country's continued inclusion in Italy's tax black list. Risks to this difficult outlook remain on the downside, particularly if financial turbulence were to again affect Europe.

41. In this context, the financial system continues to face challenges. While the extent of CRSM's total losses on its Delta investment remains uncertain at this stage, the bank will need more capital to comply with regulatory requirements and serve the economy from a position of strength. The State should stand ready to provide this additional capital, and to do so within a reasonably quick timeframe. This being said, public recapitalization going forward should, in line with international best practice, ensure that the State is entitled to a share in future profits that is commensurate with its share in the bank's capital; it should also require meaningful restructuring of the bank to return it to profitability expeditiously, with a view of reselling the State's equity to the private sector within a reasonable timeframe. Legal provisions that protect the *Fondazione San Marino Cassa di Risparmio's* majority stake must be removed.

42. While the economic crisis is leading to mounting losses on credit portfolios of other banks, their capital and liquidity buffers appear sufficient. Capital buffers outside of CRSM should be able to withstand additional further losses in a variety of scenarios. This being said, recapitalization needs cannot be excluded in these banks in a tail scenario. Liquid assets are also being rebuilt to sound levels, allowing for proper coverage of liquid liabilities. The central bank has commendably intensified supervision aimed at ensuring that banks are provisioning adequate amounts and that they remain liquid and well capitalized. Moreover, the central bank has the tools and stands ready to put in place preventive remedial actions should these be needed, though the banking law could be improved upon for more effective resolution.

43. A key lesson from the global crisis is the importance for San Marino to rebuild strong fiscal reserves, particularly in a context of significant contingent liabilities from the banks. To do so, the fiscal balance will need to gradually return to the surpluses enjoyed in the past. In this context, the government appropriately took extraordinary fiscal measures, such as the real estate tax, the surtax on general income, and restraint on public wages and capital spending. Yet these measures only helped contain the state fiscal deficit at a still high level (by San Marino's standards) of some 3 percent of GDP. With much of the GDP decline permanent thus ruling out a rapid rebound in tax revenues, some 4—5 percent of GDP in additional budgetary savings will have to be found over the medium term.

44. The planned tax reform and expenditure review constitute a great opportunity to achieve this objective. The government's tax reform plans, if enacted, will lead to a more modern, efficient, and equitable tax system, but the reform will only yield modest additional revenue: effective tax rates, which remain very low by European standards, need to be raised further than contemplated in the plan; in addition, the real estate tax needs to be made permanent, as this tax is relatively non-distortionary and a good source of revenue. Similarly, the upcoming expenditure review should start from the premise that recent efforts to contain spending have not been sufficient; outlays on public wages and health benefits are 4 percentage points of GDP higher than before the crisis, while the sustainability of the pension system is no longer assured. Returning public finances to a sound footing will require cuts in these large expenditure items, though care will have to be expended to ensure the cuts are equitable and spare the most vulnerable in society.

45. San Marino needs full normalization of relations with Italy to return to robust growth. In this regard, there has been significant progress in recent years to unwind laws protecting bank and tax secrecy. Anti money laundering laws have also been significantly tightened and the exchange of information on tax and money laundering matters has been stepped up. Continued commitment to this more open and transparent path will be the best way for San Marino to strengthen its relations with the international community.

46. In addition, the economy faces the challenge of developing new growth sectors. A shift towards asset management services will require a significant upgrade of existing know-how and infrastructure. Outside of banking, significant cost competitiveness gains—supported by recent and prospective labor market reforms—will be needed for the manufacturing sector to make up for lost activity elsewhere.

Table 1. San Marino: Selected Economic and Social Indicators, 2007–14

GDP per capita (2011): 63,650 U.S. dollars
 Population (December 2011): 32,166 persons

Life expectancy at birth (2010): 83.2 years
 Literacy, adult (2008): 96 percent

	2007	2008	2009	2010	2011	Estimate	Projection	
						2012	2013	2014
Activity and Prices								
Real GDP (percent change)	3.5	-5.1	-12.2	-7.5	-2.5	-4.0	-3.5	0.0
Domestic demand	..	-6.4	-10.5	-10.4	-1.0	..	..	..
Final consumption	..	-2.3	0.2	-6.3	-1.8	..	..	..
Fixed investment	..	-5.9	-15.5	-20.0	1.6	..	..	..
Net exports (contribution to growth)	..	-0.3	-4.4	0.4	-1.8	..	..	..
Exports	..	1.5	-18.3	-12.1	-12.4	..	..	..
Imports	..	1.8	-18.5	-14.0	-13.3	..	..	..
Employment (percent change)	3.2	3.5	-0.3	-0.8	-2.2	-1.0	..	..
Unemployment rate (average; percent)	3.0	3.1	4.5	4.9	5.5	6.9	..	..
Inflation rate (average; percent)	2.5	4.1	2.4	2.6	2.0	2.8	1.6	0.9
Nominal GDP (millions of euros)	1832.0	1768.1	1610.3	1484.6	1460.7	1442.2	1414.2	1426.3
Public Finances (percent of GDP) 1/								
Revenues	21.8	21.0	20.6	22.8	20.7	20.5	20.1	20.1
Expenditure	20.2	20.8	22.8	24.9	24.4	23.4	23.0	23.2
Overall balance	1.6	0.2	-2.3	-2.1	-3.6	-2.9	-2.9	-3.1
Government debt	11.3	14.4	18.5	19.2	18.6	20.3	25.8	28.6
Loans	3.5	3.7	3.9	3.8	3.2	6.9	12.1	15.1
Net account payables	7.8	10.6	14.6	15.4	15.4	13.4	13.7	13.5
Government deposits (millions of euros)	214.4	263.9	256.9	218.2	154.1	72.9	72.9	72.9
Money and Credit								
Deposits (percent change)	..	16.1	-18.7	-18.0	-12.5	-1.6	..	..
Private sector credit (percent change)	13.6	12.2	-5.5	-6.6	-20.0	-13.3	..	..
Net foreign assets (percent of GDP)	39.0	31.0	9.7	27.6	47.0	36.5	..	..
Commercial banks	15.0	2.3	-23.3	6.2	30.1	20.8	..	..
Central bank	24.0	28.7	33.0	21.4	16.8	15.7	..	..
External Accounts (percent of GDP)								
Balance of goods and services	24.6	24.7	25.4	26.1	23.4	..	..	..
Exports	207.4	223.5	204.7	195.8	176.6	..	..	..
Imports	182.8	198.8	179.3	169.8	153.3	..	..	..
Gross international reserves (millions of U.S. dollars)	647.8	706.8	790.3	449.2	341.9	308.6	..	..
Exchange Rate (average)								
Euros per U.S. dollar	0.73	0.68	0.72	0.76	0.72	0.78	..	..
Real exchange rate vis-à-vis Italy	100.66	101.37	103.05	104.12	103.37	103.16	..	..
Financial Soundness Indicators (percent) 2/								
Regulatory capital to risk-weighted assets	17.5	16.9	16.9	15.6	14.1	12.5	..	..
Bad loans to total loans	n.a.	n.a.	2.9	5.9	10.1	9.9	..	..
Loan loss provision to total loans 3/	4.3	2.6	3.9	6.3	10.5	10.9	..	..
Return on equity (ROE)	12.1	10.0	-14.4	-24.4	-24.4	-21.1	..	..
Liquid assets to total assets	..	..	..	..	..	11.9	..	..
Liquid assets to short-term liabilities	..	..	..	..	..	37.5	..	..

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

1/ For the central government. Does not include possible costs of future bank recapitalization as well as potential savings from the planned tax reform and expenditure review.

2/ For 2012, latest available.

3/ Based on total loan loss provision, which covers nonperforming and performing loans.

Table 2. San Marino: Financial Soundness Indicators, 2007–12

	2007	2008	2009	2010	2011	2012 1/
Capital adequacy ratios (percent)						
Regulatory capital to risk-weighted assets	17.5	16.9	16.9	15.6	14.1	12.5
Capital to assets	10.8	10.7	11.1	9.9	9.6	8.8
Asset quality ratios (percent)						
Bad loans to total loans	...	...	2.9	5.9	10.1	9.9
Nonperforming loans to total loans	...	4.2	8.5	15.0	23.5	24.4
Bad loans net of provision to capital	...	...	7.2	17.6	28.6	11.0
Nonperforming loans net of provision to capital	...	...	22.9	52.5	77.3	84.2
Loan loss provision to total loans 2/	4.3	2.6	3.9	6.3	10.5	10.9
Earning and profitability (percent)						
Return on assets (ROA) 3/	1.2	0.8	-1.4	-2.7	-6.6	-2.2
Return on assets (ROA) 4/	1.3	1.1	-1.6	-2.6	-2.4	-1.9
Return on equity (ROE) 3/	10.7	7.6	-13.1	-25.2	-67.9	-23.8
Return on equity (ROE) 4/	12.1	10.0	-14.4	-24.4	-24.4	-21.1
Interest margin to gross income	81.2	100.9	51.4	49.0	65.8	59.7
Non-interest expenses to gross income	36.7	45.2	52.2	68.5	83.2	80.7
Trading income to gross income	-7.8	-29.1	11.0	1.3	-7.0	11.5
Administrative expenses to non-interest expenditures	84.0	83.5	51.3	61.9	69.2	80.5
Liquidity (percent)						
Liquid assets to total assets	...	...	...	...	...	11.9
Liquid assets to short-term liabilities	...	...	...	...	...	37.5
Loans to deposits	77.1	75.2	88.5	101.4	91.6	108.7
Interest rates (basis points)						
Spread between lending and deposit rates	495.5	566.5	478.0	467.5	483.8	520.3
Assets						
Financial system (millions of euros)	15,171.8	16,354.5	12,804.4	10,506.6	8,578.6	8,265.8
percent of GDP	828.1	925.0	795.2	707.7	587.3	573.1
Banks (millions of euros)	10,415.4	11,535.5	9,447.2	8,090.9	6,721.2	6,569.8
percent of GDP	568.5	652.4	586.7	545.0	460.1	455.5

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

1/ Latest available.

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

3/ Before extraordinary items and taxes.

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

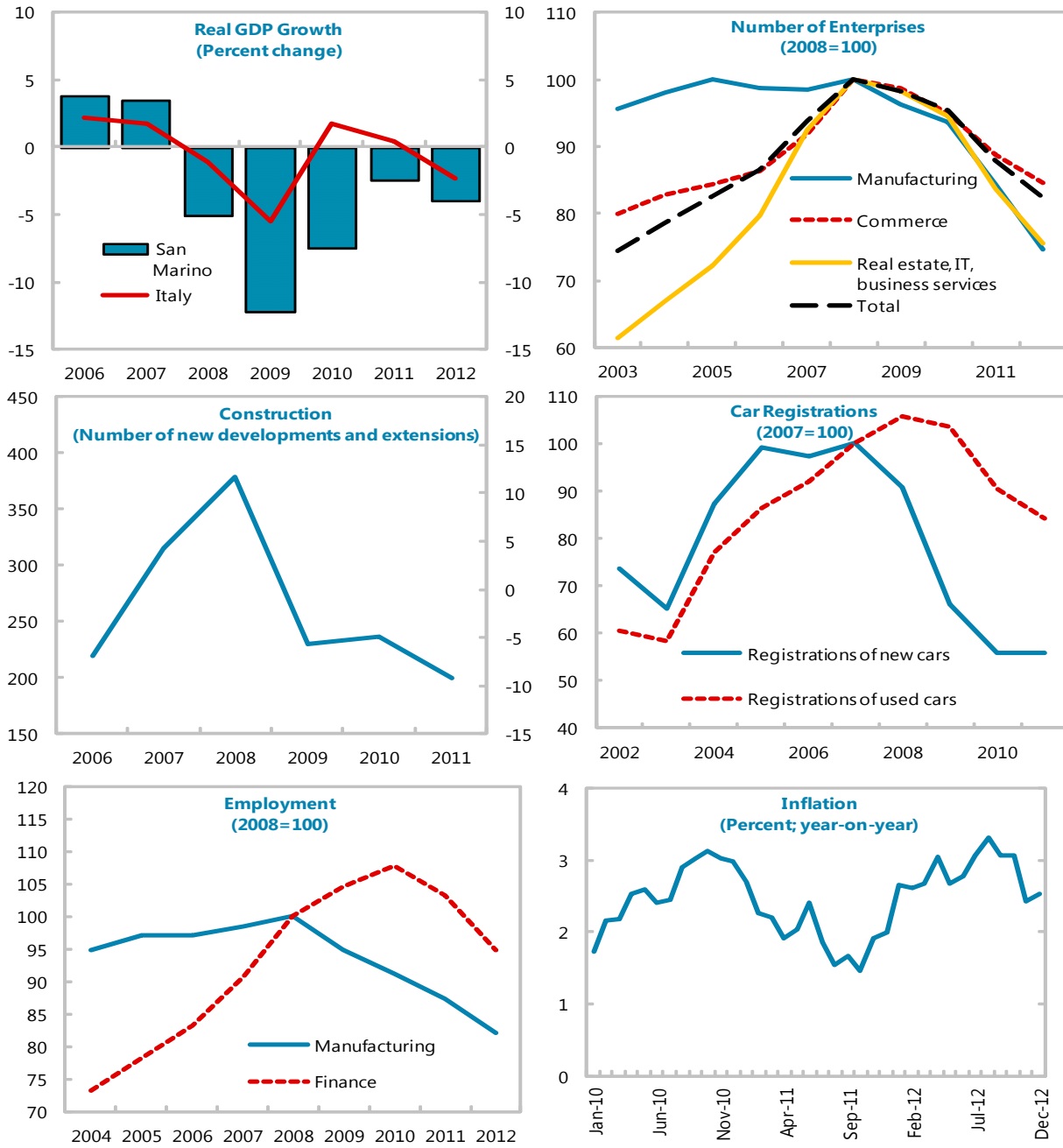
Table 3. San Marino: Government Operations, 2008–18
(Percent of GDP)

	2008	2009	2010	2011	Estimate		Projection				
					2012	2013	2014	2015	2016	2017	2018
Central government 1/											
Revenue	21.0	20.6	22.8	20.7	20.5	20.1	20.1	20.1	20.1	20.1	20.1
Taxes	16.9	15.9	17.6	15.5	15.6	15.0	15.0	15.0	15.0	15.0	15.0
Income Taxes	6.6	6.3	7.5	6.6	6.3	6.0	6.0	6.0	6.0	6.0	6.0
Non-income taxes	10.3	9.6	10.2	8.9	9.3	9.0	9.0	9.0	9.0	9.0	9.0
Taxes on international trade and transactions	7.2	6.5	7.2	6.3	6.0	5.8	5.8	5.8	5.8	5.8	5.8
Other taxes	3.1	3.1	3.0	2.5	3.3	3.2	3.2	3.2	3.2	3.2	3.2
Non-tax revenue	4.1	4.7	5.1	5.3	4.9	5.1	5.1	5.1	5.1	5.1	5.1
Expenditure	20.8	22.8	24.9	24.4	23.4	23.0	23.2	23.3	23.4	23.5	23.5
Expense	19.1	21.3	24.1	23.3	22.0	21.7	21.8	21.9	22.0	22.1	22.2
Compensation of employees	6.3	7.1	7.9	7.8	8.2	8.3	8.3	8.3	8.3	8.3	8.3
Use of goods and services	1.6	1.9	2.0	2.0	2.3	2.1	2.1	2.1	2.1	2.1	2.1
Interest	0.2	0.1	0.1	0.1	0.1	0.2	0.4	0.5	0.6	0.7	0.7
Grants	9.5	11.1	11.4	10.4	10.1	10.0	10.0	10.0	10.0	10.0	10.0
Current	7.9	8.9	9.5	8.8	9.4	9.4	9.4	9.4	9.4	9.4	9.4
Capital	1.6	2.2	1.9	1.6	0.7	0.5	0.5	0.5	0.5	0.5	0.5
Other expenses (including subsidies)	1.5	1.1	2.7	3.1	1.3	1.1	1.1	1.1	1.1	1.1	1.1
Net acquisition of non-financial assets	1.7	1.5	0.9	1.0	1.3	1.4	1.4	1.4	1.4	1.4	1.4
Net lending (+)/borrowing (-) (fiscal balance)	0.2	-2.3	-2.1	-3.6	-2.9	-2.9	-3.1	-3.2	-3.3	-3.4	-3.5
Net financial worth, transactions	0.2	-2.3	-2.1	-3.6	-2.9	-2.9	-3.1	-3.2	-3.3	-3.4	-3.5
Net acquisition of financial assets	1.0	-6.3	-4.4	-5.7	-2.4	2.1	0.0	0.0	0.0	0.0	0.0
Currency and deposits	2.8	-0.4	-2.6	-4.4	-5.6	0.0	0.0	0.0	0.0	0.0	0.0
Other accounts receivable	-1.8	-5.8	-1.8	-1.3	1.1	0.0	0.0	0.0	0.0	0.0	0.0
Investment in CRSM					2.1	2.1	0.0	0.0	0.0	0.0	0.0
Net incurrence of liabilities	0.9	-4.0	-2.3	-2.1	0.4	5.1	3.1	3.2	3.3	3.4	3.5
Loans	-0.2	-0.3	-0.5	-0.6	1.5	5.1	3.1	3.2	3.3	3.4	3.5
Other accounts payable	1.1	-3.7	-1.8	-1.5	-1.1	0.0	0.0	0.0	0.0	0.0	0.0
Consolidated Budget (Central Government and Social Security)											
Total revenue	31.5	32.7	35.6	33.5	32.9	...	...	...	...	...	...
Of which: social security contributions	9.3	10.7	11.3	11.0	10.6	...	...	...	...	...	...
Total expenditure	29.1	33.7	35.2	36.3	33.9	...	...	...	...	...	...
Of which: health spending	4.0	4.6	5.1	5.4	5.7	...	...	...	...	...	...
Of which: pension benefits	5.5	6.5	7.6	8.1	8.6	...	...	...	...	...	...
Overall balance	2.4	-1.0	0.4	-2.9	-1.1	...	...	...	...	...	...
<i>Memorandum items</i>											
Public debt	14.4	18.5	19.2	18.6	20.3	25.8	28.6	31.2	33.8	36.2	38.7
Loans	3.7	3.9	3.8	3.2	6.9	12.1	15.1	18.0	20.8	23.6	26.4
Net accounts payable	10.6	14.6	15.4	15.4	13.4	13.7	13.5	13.3	12.9	12.6	12.2
Central government deposits	14.9	16.0	14.7	10.5	5.1	5.2	5.1	5.0	4.9	4.8	4.6
Social security pension deposits	12.6	16.0	20.4	23.4	26.5	...	...	...	...	...	...
Nominal GDP (millions of euros)	1768.1	1610.3	1484.6	1460.7	1442.2	1414.2	1426.3	1457.4	1492.8	1532.7	1577.6

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

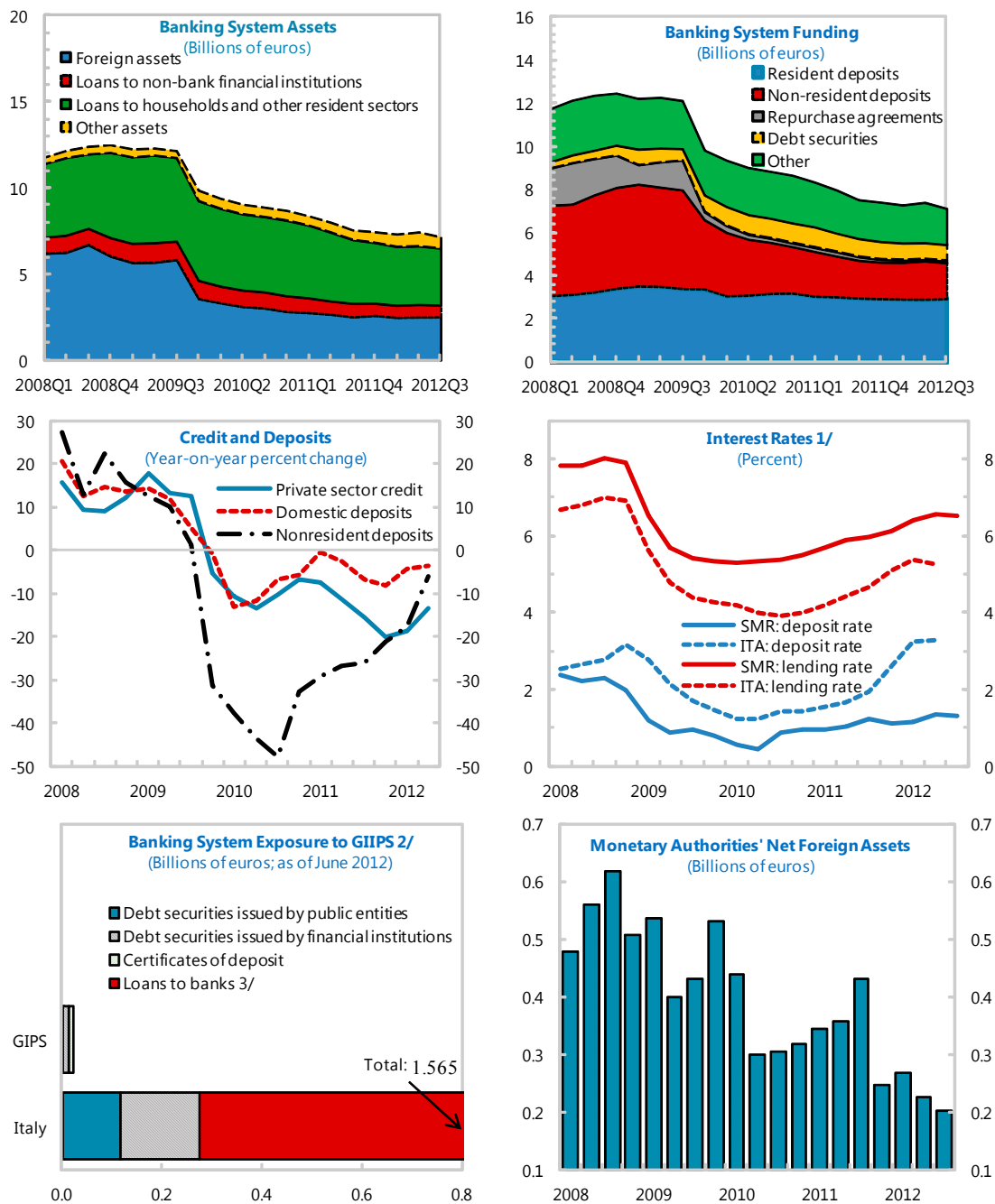
1/ Does not include possible costs of future bank recapitalization as well as potential savings from the planned tax reform and expenditure review.

Figure 1. San Marino: Recent Economic Developments, 2002-12



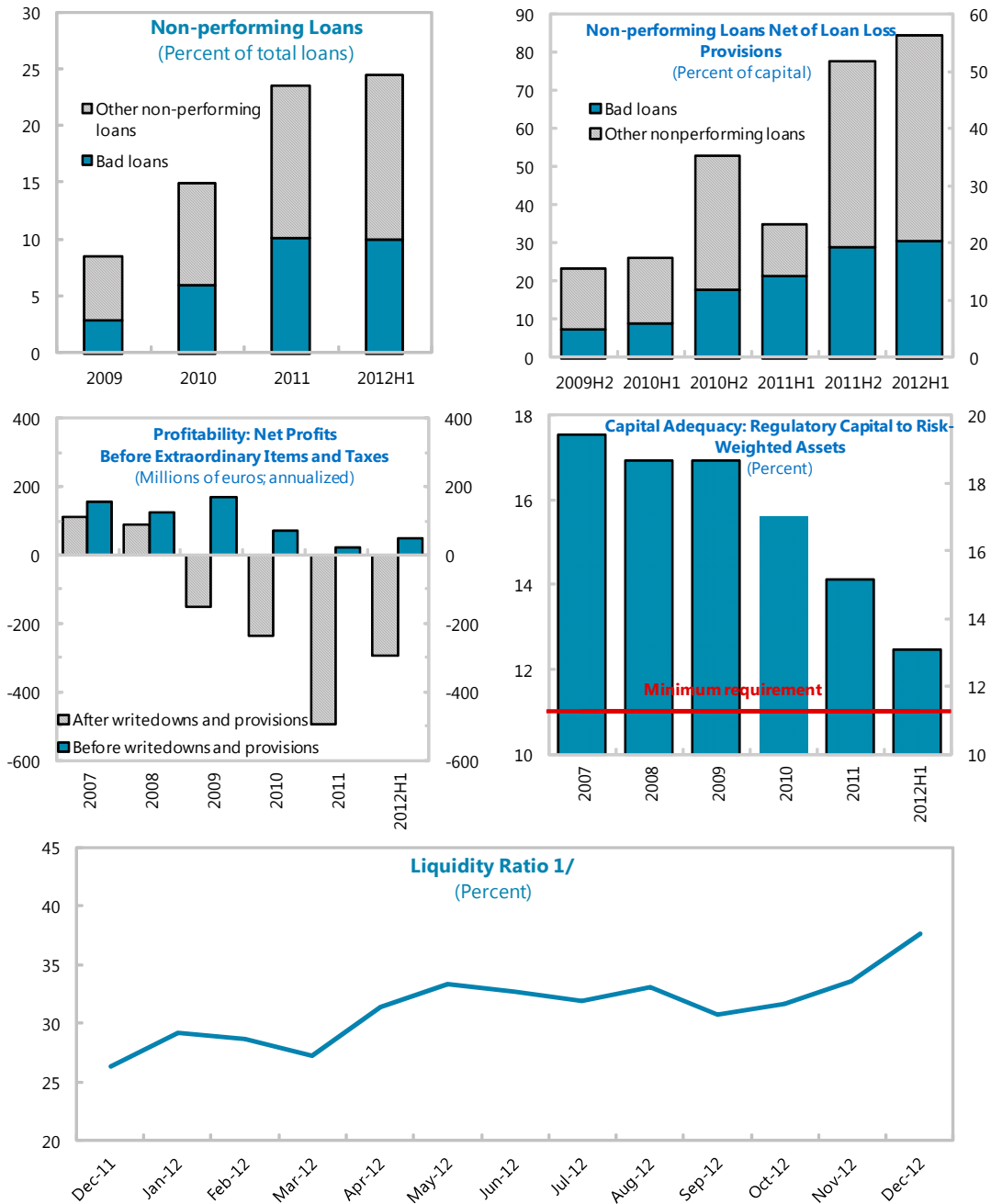
Sources: CBSM; IMF, International Financial Statistics; UPECEDS; and IMF staff calculations.

Figure 2. San Marino: Financial Sector Indicators, 2008–12



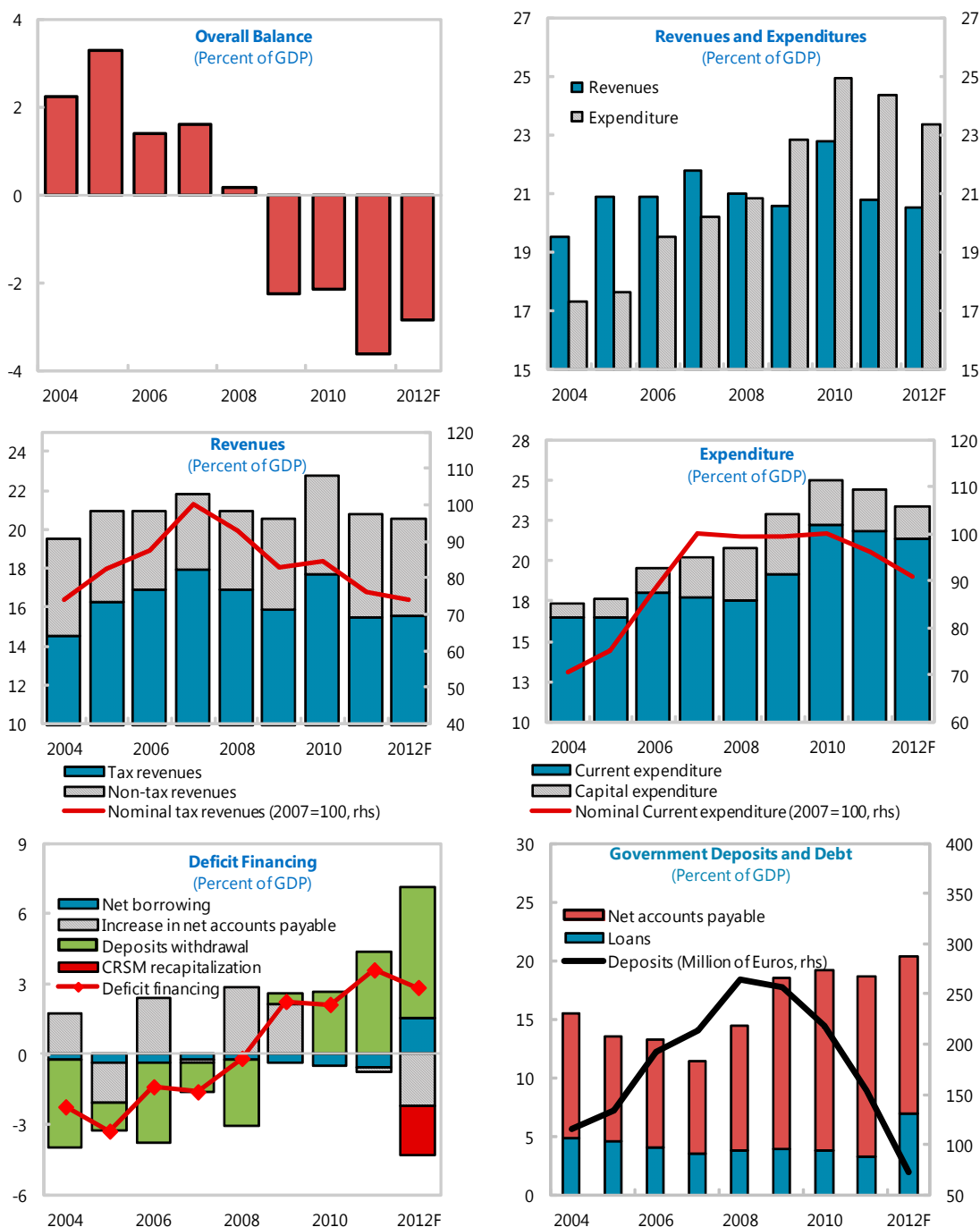
Sources: CBSM; IMF, International Financial Statistics; UPECEDS; and IMF staff calculations and estimates.
 1/ For San Marino, based on time deposit rate. For Italy, based on deposit rate for households with maturity up to 2 years (stock basis). Based on comparable series (which was discontinued in 2003),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

Figure 3. San Marino: Banking System Financial Soundness Indicators, 2007–12



Sources: CBSM; IMF, International Financial Statistics; UPECEDES; and IMF staff calculations.
 1/ Liquid assets as a share of liquid liabilities, excluding inter-bank loans.

Figure 4. San Marino: Fiscal Indicators for Central Government, 2004–12



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

Appendix I: Risk Assessment Matrix¹

	Risk	Relative likelihood	Impact if realized
Short-term risks	Stalled or incomplete delivery of Euro area policy commitments (financial stress re-emerges and bank-sovereign links re-intensify)	Medium	High San Marino's economy is highly dependent on the situation in neighboring Italy via trade, tourism, and financial links
	Failure to set CRSM on a sound financial footing	Medium	High CRSM accounts for one third of the banking system, hence it would have systemic implications
Medium-term risks	Protracted period of slower European growth (larger than expected deleveraging or negative surprise on potential growth)	Medium	Medium Given extensive links to Italy, this would likely entail slow growth in San Marino as well
	Tensions with neighboring Italy are not fully resolved	Low	High Continued tensions would discourage Italian financial and non-financial from engaging in business in San Marino or with Sammarinese counterparts

¹ The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline. The RAM reflects staff views on the source of the risks and overall level of concern as of the time of the discussion with the authorities.

Appendix II: Public Debt Sustainability Analysis

- 1. In the baseline excluding recapitalization costs, public debt would increase substantially but remain manageable.** In this scenario, debt would go from 20 percent of GDP in 2012 to slightly less than 40 percent in 2018. The reason is that, in the absence of further consolidation measures, primary deficits will remain in the 2½–3 percent of GDP range, while the economy is expected to grow very little in cumulative terms over 2013–2018 period. Nevertheless, it should be noted that about 13 percent of GDP in starting debt are actually unclaimed tax refunds that do not carry interest and are typically rolled over from one year to the next. Hence, the “actual” debt in the baseline at the end of the projection period is closer to 26 percent of GDP. This is significantly higher than the 7 percent of GDP now, but still manageable.
- 2. Bank recapitalization costs could severely complicate the debt situation.** As mentioned in the main text, the largest bank in the system will need more capital, and this capital might have to be injected by the State. To estimate the impact on public debt, staff follow two assumptions: a lower-bound estimate of recapitalization needs of about 10 percent of GDP, and an upper-bound estimate of 25 percent of GDP. Recapitalization is assumed to occur in 2013. In both scenarios, public debt would rise sharply, going from 20 percent of GDP in 2012 to about 50 and 70 percent of GDP, respectively (or 37 and 58 percent of GDP in “actual” debt adjusting for the unclaimed tax refunds). This being said, the State would acquire an asset such as equity in the bank in exchange for recapitalization funds. This asset could help unwind debt if sold back to the market at a later stage.
- 3. Still, contingent liabilities highlight the need to consolidate public finances.** While bank recapitalization triggers a jump in debt in 2013, the significant increase in debt thereafter is due to ongoing fiscal deficits. Thus, stabilizing debt post-recapitalization would require fiscal consolidation. As an example, if the government were to tighten the budget by one percentage point of GDP per year for each of the next four years, then in the mild recapitalization scenario public debt would start falling from 2015 onwards and end at 33 percent of GDP in 2018, versus 50 percent without consolidation; in the severe recapitalization scenario, debt would stabilize post-recapitalization jump, and end at 55 percent versus 71 percent without consolidation.
- 4. Under plausible scenarios, the impact from weaker growth would be not as severe as that from recapitalization.** Assuming that growth is 1½ percentage points of GDP weaker each year would bring debt at the end of the period to 47 percent of GDP (or 34 percent in “actual” debt).¹ This would be similar to the lower bound recapitalization scenario, but significantly less burdensome than the severe recapitalization scenario.

¹ The standard DSA growth shock of half a standard deviation decline would be implausibly harsh, as it would imply that growth would be 3½ percentage points lower every year than in the baseline. The assumed shock is still quite severe.

San Marino: Government Debt Sustainability Framework, 2006–18

(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	2018	
Baseline: Government debt 1/	13.3	11.3	14.4	18.5	19.2	18.6	20.3	25.8	28.6	31.2	33.8	36.2	38.7	1.9
Change in government debt	-0.3	-1.9	3.0	4.1	0.6	-0.5	1.7	5.5	2.9	2.6	2.5	2.5	2.4	
Identified debt-creating flows	1.4	-1.1	2.5	2.1	-0.4	-0.8	-0.7	5.4	3.5	3.5	3.7	3.8	3.9	
Primary deficit	-1.4	-1.8	-0.4	2.1	2.1	3.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7	
Revenue	20.9	21.8	21.0	20.6	22.8	20.7	20.5	20.1	20.1	20.1	20.1	20.1	20.1	
Non-interest expenditure	19.5	20.0	20.6	22.7	24.8	24.3	23.3	22.8	22.8	22.8	22.8	22.8	22.8	
Automatic debt dynamics 2/	-0.1	-0.2	0.3	0.4	0.3	0.1	0.1	0.6	0.8	0.8	0.9	1.0	1.1	
Contribution from interest rate and growth differential 3/	-0.1	-0.2	0.3	0.4	0.3	0.1	0.1	0.6	0.8	0.8	0.9	1.0	1.1	
Of which: from real interest rate	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.4	0.8	0.9	1.1	1.3	1.5	
Of which: from real GDP growth	-0.2	-0.2	0.2	0.4	0.2	0.1	0.1	0.2	0.0	-0.1	-0.2	-0.2	-0.3	
Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	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	-4.4	-3.5	2.1	0.0	0.0	0.0	0.0	0.1	
Reduction in deposits (entered as negative)	3.4	1.2	2.8	-0.4	-2.6	-4.4	-5.6	0.0	0.0	0.0	0.0	0.0	0.0	
Asset sale (entered as negative)	-0.1	0.0	-0.1	-0.1	0.0	0.0	2.1	2.1	0.0	0.0	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	0.1	
Residuals 5/	-1.7	-0.9	0.5	2.0	1.1	0.2	2.3	0.1	-0.6	-1.0	-1.1	-1.3	-1.5	
Government debt to revenue ratio 1/	63.5	52.1	68.6	90.0	84.1	89.9	99.0	128.3	142.6	155.4	168.0	180.4	192.5	
Gross financing need 6/	-0.6	-1.2	0.3	2.8	2.7	4.2	3.4	3.5	4.0	4.1	4.1	4.2	4.3	
Millions of euros	-10.7	-21.5	5.5	45.3	40.0	60.9	49.2	49.7	57.1	59.4	61.9	64.5	67.4	
Millions of U.S. dollars	-14.0	-31.6	7.7	65.3	53.4	78.8	63.9	66.5	75.9	78.3	81.0	84.5	88.3	
Scenario with key variables at their historical averages 7/	...	...	...	...	...	...	...	23.6	24.3	24.7	24.8	24.6	24.2	1.2
Scenario with no policy change (constant primary bal.) in 2012 - 2017	...	...	...	...	...	...	...	25.6	28.3	30.8	33.3	35.6	38.0	1.9
Key macroeconomic and fiscal assumptions														
Real GDP growth (percent)	3.8	6.8	-5.1	-12.2	-7.5	-2.5	-4.0	-3.5	0.0	1.0	1.1	1.3	1.4	
Inflation (change in GDP deflator, percent)	2.0	2.8	1.7	3.8	-0.4	0.9	2.8	1.6	0.9	1.2	1.3	1.4	1.5	
Nominal interest rate (percentage points) 8/	4.3	5.0	6.0	4.0	2.6	3.3	2.5	7.6	8.1	8.1	8.1	8.1	8.1	
Real interest rate (percent)	2.3	2.1	4.3	0.2	3.0	2.4	-0.3	6.0	7.2	6.9	6.8	6.7	6.6	
Exchange rate appreciation (increase in U.S. dollar value of local currency, percent)	11.6	11.8	-5.5	3.5	-7.2	-3.2	0.4	3.1	-0.7	-0.7	-0.7	0.0	0.0	
Growth of real revenue (percent)	3.8	11.3	-8.7	-13.9	2.5	-11.2	-5.2	-5.4	0.0	1.0	1.1	1.3	1.4	
Growth of real non-interest expenditure (percent)	14.3	9.9	-2.3	-3.3	1.3	-4.7	-8.0	-5.4	0.0	1.0	1.1	1.3	1.4	
Primary deficit	-1.4	-1.8	-0.4	2.1	2.1	3.5	2.8	2.7	2.7	2.7	2.7	2.7	2.7	

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

1/ Based on central government liabilities which includes about 13 percent of GDP in unclaimed tax refunds.

2/ Derive as $[r - \pi(1+g) - g + \alpha(1+r)] / (1+g+\pi+g\pi)$ 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 $r - \pi(1+g)$, and the real GDP growth contribution as $-g$.

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

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

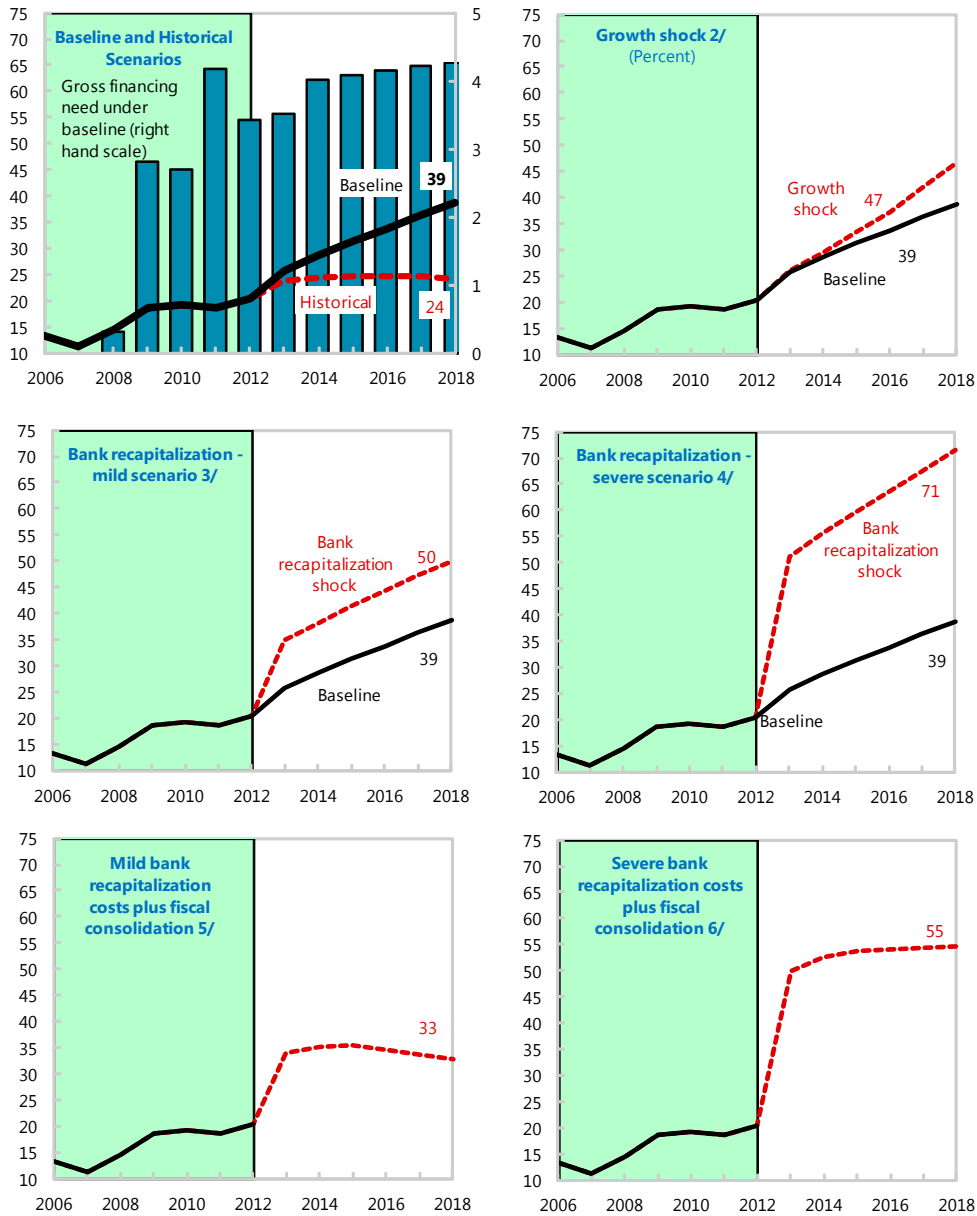
6/ Defined as budget deficit, plus amortization of medium- and long-term public sector debt, plus short-term debt (not being rolled over automatically) at end of previous period, plus extraordinary items (e.g. recognition of contingent or implicit liabilities, and bank recapitalization).

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.

San Marino: Government Debt Sustainability—Bound Tests, 2006–18 1/ (Percent of GDP)



Source: IMF staff estimates.

1/ Shaded areas represent actual data. Government debt is based on central government liabilities, which include about 13 percent of GDP in unclaimed tax refunds.

2/ Assumed shock: growth is 1.5 percentage points lower than in the baseline in every projection year.

3/ Assumed recapitalization cost of 9 percent of GDP.

4/ Assumed recapitalization cost of 25 percent of GDP.

5/ Assumed recapitalization cost of 9 percent of GDP, and fiscal consolidation of 1 percent of GDP per year over 2013–16.

6/ Assumed recapitalization cost of 25 percent of GDP, and fiscal consolidation of 1 percent of GDP per year over 2013–16.



REPUBLIC OF SAN MARINO

April 18, 2013

STAFF REPORT FOR THE 2013 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department
(In Consultation with Other Departments)

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FUND RELATIONS

(As of March 28, 2013)

Membership Status

Joined: September 23, 1992; Article VIII

General Resources Account	SDR Million	Percent of Quota
Quota	22.40	100.00
Fund holdings of currency	16.95	75.67
Reserves tranche position	5.45	24.34

SDR Department	SDR Million	Percent of Allocation
Net cumulative allocation	15.53	100.00
Holdings	15.38	98.98

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

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.

Article IV Consultation

San Marino is on a 12-month cycle. The previous Article IV consultation discussions took place during February 21–March 2, 2012, and the consultation was concluded on April 27, 2012 (Country Report No. 12/108).

FSAP Participation

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

Technical Assistance

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

Resident Representative: None

STATISTICAL ISSUES

(As of March 28, 2013)

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 2004–12, as well as the budget for 2013–15. However, the data have not been compiled in accordance with IMF standards. 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 had not considered this a high priority. This will change, however, as the authorities are set to receive Fund technical assistance on BOP statistics. Starting in 2008, trade statistics have been released quarterly with a lag of about six months.

San Marino: Table of Common Indicators Required for Surveillance
(As of March 28, 2013)

	Date of latest observation	Date received	Frequency of Data ⁵	Frequency of Reporting ⁵	Frequency of Publication ⁵
Exchange Rates	3/28/13	3/28/13	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Q3 2012	Feb 2013	Q	Q	Q
Reserve/Base Money	Q3 2012	Feb 2013	Q	Q	Q
Broad Money	Q3 2012	Feb 2013	Q	Q	Q
Central Bank Balance Sheet	Q3 2012	Feb 2013	Q	Q	Q
Consolidated Balance Sheet of the Banking System	Q3 2012	Feb 2013	Q	Q	Q
Interest Rates ²	Q3 2012	Feb 2013	Q	Q	Q
Consumer Price Index	Dec 2012	Feb 2013	M	M	M
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	Q3 2012	Feb 2013	A	A	A
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	Q3 2012	Feb 2013	A	A	A
Stocks of Central Government and Central Government-Guaranteed Debt	Q3 2012	Feb 2013	A	A	A
External Current Account Balance	NA ⁶				
Exports and Imports of Goods and Services	2011	Feb 2013	A	A	A
GDP/GNP	2011	Feb 2013	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 Lack of capacity precludes the compilation of balance of payments data at present. Fund technical assistance in this area is forthcoming.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 13/54
FOR IMMEDIATE RELEASE
May 17, 2013

International Monetary Fund
700 19th Street, NW
Washington, DC 20431 USA

IMF Executive Board Concludes 2013 Article IV Consultation with the Republic of San Marino

On May 3, 2013, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with San Marino.¹

Background

San Marino is experiencing a deep and prolonged recession, with the decline in GDP since 2007 amounting to a cumulative 28 percent. The global financial crisis put an end to the traditional business model built around bank and tax secrecy, bringing about a large outflow of non-resident deposits and an associated compression of banks' balance sheets. Weak external demand and the difficulties faced by many Sammarinese firms due to the country's continued inclusion in Italy's tax black list have also contributed to the recession.

System-wide deposit outflows have now abated, and preliminary indications point to an increase in deposits in some institutions in recent months. This is allowing banks to gradually rebuild their liquidity buffers. However, Cassa di Risparmio della Repubblica di San Marino, the largest bank, remains undercapitalized following heavy losses from its investment in the Italian Delta group. Moreover, the economic recession is leading to mounting non-performing loans across all

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>.

banks, with the gross non-performing loan ratio now close to 25 percent for the system as a whole.

The global crisis has led to a significant decline in budget revenues. However, San Marino's sizable pre-2008 budget surplus, combined with recent tax measures and efforts to restrain expenditures, have helped contain the deficit at some 3 percent of GDP. Fiscal reserves accumulated before the crisis have been used to finance recent budget deficits thereby keeping public debt low, but these reserves are now largely exhausted.

International assessments have recognized the progress made by San Marino in unwinding laws protecting bank and tax secrecy, while the exchange of information with other jurisdictions has also been stepped up. San Marino has recently ratified key agreements with Italy on double taxation and prevention of tax fraud, financial cooperation, and economic cooperation, which now await ratification by the Italian parliament.

Executive Board Assessment

Executive Directors noted that San Marino's economy is facing financial and fiscal challenges in the near term, as well as uncertain medium-term prospects. Accordingly, Directors emphasized the need to preserve financial stability, rebuild fiscal buffers, and push ahead with structural reforms to develop new sources of growth.

Directors considered that, notwithstanding the recent recapitalization, the largest bank will need more capital to meet prudential requirements. They agreed that, if public capital is injected, the state should acquire equity in the bank commensurate with its share in the recapitalization, and take control of its management and board. A credible restructuring plan will also be needed to bring the bank back to profitability.

Directors noted with satisfaction that the banks' large liquidity buffers should accommodate further potential deposit outflows, and that their capital positions are generally strong—the largest bank excepted. Nonetheless, they cautioned against complacency given rising non-performing loans, and welcomed the authorities' heightened oversight of the banking system. Although bank resolution tools are generally effective, Directors stressed the importance of establishing the central bank as the sole authority for bank resolution.

Directors welcomed the authorities' intention to rebuild fiscal buffers, in view of the economic uncertainties and large contingent liabilities from the banking system. Although the planned tax reform would make the tax system more efficient, Directors felt that fiscal adjustment in the period ahead would be more effective if some tax exemptions in the plan are reversed or the decline in personal income tax rates is more limited. Directors also noted that the current level

of public wages, pensions, and health spending is unsustainable, and recommended cutting back outlays in these areas, while protecting the most disadvantaged.

Directors welcomed the steps taken to dismantle tax and bank secrecy, and the increased exchange of information with other jurisdictions. Recent cooperation agreements with Italy, once ratified, will further entrench San Marino's commitment toward openness and transparency. Directors agreed that further improvement of relations with Italy is a necessary condition for a revival of the Sammarinese economy and its growth drivers.

Directors noted the critical challenge of finding new growth sectors to replace lost activities in San Marino. They stressed the need to improve cost competitiveness and looked forward to implementation of planned labor market reforms.

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 2013 Article IV Consultation with The Republic of San Marino is also available.

San Marino: Selected Economic and Social Indicators, 2008–14

GDP per capita (2011): 63,650 U.S. dollars
 Population (December 2011): 32,166 persons

Life expectancy at birth (2010): 83.2 years

Literacy, adult (2008): 96 percent

	2008	2009	2010	2011	Estimate 2012	Projection 2013	2014
Activity and Prices							
Real GDP (percent change)	-5.1	-12.2	-7.5	-2.5	-4.0	-3.5	0.0
Domestic demand	-6.4	-10.5	-10.4	-1.0	...	...	...
Final consumption	-2.3	0.2	-6.3	-1.8	...	...	...
Fixed investment	-5.9	-15.5	-20.0	1.6	...	...	...
Net exports (contribution to growth)	-0.3	-4.4	0.4	-1.8	...	...	...
Exports	1.5	-18.3	-12.1	-12.4	...	...	...
Imports	1.8	-18.5	-14.0	-13.3	...	...	...
Employment (percent change)	3.5	-0.3	-0.8	-2.2	-1.0	...	...
Unemployment rate (average; percent)	3.1	4.5	4.9	5.5	6.9	...	...
Inflation rate (average; percent)	4.1	2.4	2.6	2.0	2.8	1.6	0.9
Nominal GDP (millions of euros)	1768.1	1610.3	1484.6	1460.7	1442.2	1414.2	1426.3
Public Finances (percent of GDP) 1/							
Revenues	21.0	20.6	22.8	20.7	20.5	20.1	20.1
Expenditure	20.8	22.8	24.9	24.4	23.4	23.0	23.2
Overall balance	0.2	-2.3	-2.1	-3.6	-2.9	-2.9	-3.1
Government debt	14.4	18.5	19.2	18.6	20.3	25.8	28.6
Loans	3.7	3.9	3.8	3.2	6.9	12.1	15.1
Net account payables	10.6	14.6	15.4	15.4	13.4	13.7	13.5
Government deposits (millions of euros)	263.9	256.9	218.2	154.1	72.9	72.9	72.9
Money and Credit							
Deposits (percent change)	16.1	-18.7	-18.0	-12.5	-1.6	...	...
Private sector credit (percent change)	12.2	-5.5	-6.6	-20.0	-13.3	...	...
Net foreign assets (percent of GDP)	31.0	9.7	27.6	47.0	36.5	...	...
Commercial banks	2.3	-23.3	6.2	30.1	20.8	...	...
Central bank	28.7	33.0	21.4	16.8	15.7	...	...
External Accounts (percent of GDP)							
Balance of goods and services	24.7	25.4	26.1	23.4	...	...	...
Exports	223.5	204.7	195.8	176.6	...	...	...
Imports	198.8	179.3	169.8	153.3	...	...	...
Gross international reserves (millions of U.S. dollars)	706.8	790.3	449.2	341.9	308.6	...	...
Exchange Rate (average)							
Euros per U.S. dollar	0.68	0.72	0.76	0.72	0.78	...	...
Real exchange rate vis-à-vis Italy	101.37	103.05	104.12	103.37	103.16	...	...
Financial Soundness Indicators (percent) 2/							
Regulatory capital to risk-weighted assets	16.9	16.9	15.6	14.1	12.5	...	...
Bad loans to total loans	n.a.	2.9	5.9	10.1	9.9	...	...
Loan loss provision to total loans 3/	2.6	3.9	6.3	10.5	10.9	...	...
Return on equity (ROE)	10.0	-14.4	-24.4	-24.4	-21.1	...	...
Liquid assets to total assets	...	...	...	...	11.9	...	...
Liquid assets to short-term liabilities	...	...	...	...	37.5	...	...

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

1/ For the central government. Does not include possible costs of future bank recapitalization as well as potential savings from the planned tax reform and expenditure review.

2/ For 2012, latest available.

3/ Based on total loan loss provision, which covers nonperforming and performing loans.

**Statement by Andrea Montanino, Executive Director for San Marino
And Ms. Daniela Marchettini, Advisor to Executive Director
May 3, 2013**

The authorities thank the staff for the helpful discussions held in San Marino and for their thorough analysis, which they broadly share. They are keen to continue the reform process started since the beginning of the financial crisis and will remain in close contact with the staff so as to keep them abreast of the impact of the reforms on the economy, including, if compatible with the IMF resources envelope, in the context of technical assistance.

Introduction

Over the past few years, San Marino's economy has been hit by a confluence of shocks, mostly connected to the global financial crisis and the international pressures to embrace greater transparency standards and rethink the tax-haven status. The crisis has triggered a cumulative 28 percent contraction of San Marino's GDP since 2007, of which a large part is estimated to be permanent, as well as a significant consolidation of its large banking sector. However, the large fiscal buffers accumulated before the crisis and the bold actions undertaken by the authorities helped prevent an outright meltdown of the financial sector and mitigated the negative impact on output.

San Marino is now at a critical juncture. Reforming the economic model and identifying new and sustainable sources of growth are fundamental steps to offset the abrupt contraction of potential output. The authorities are fully aware of this situation and, in addition to the efforts to manage the crisis, are focusing on the medium-term challenges, including restoring fiscal sustainability, completing the overhaul of the banking system, and laying the foundations for a new and sustainable business model.

In order to facilitate a successful repositioning of the economy, the authorities consider fundamental the normalization of the economic and financial relations with Italy. To achieve this goal, San Marino is working actively to shedding the legacy of its past as a tax haven. In this context, the authorities have made important progress towards openness and transparency. International, peer-reviewed assessments have confirmed this progress. In particular, the latest MONEYVAL¹ assessment on Anti Money Laundering and Combating the Financing of Terrorism (AML/CFT) issues in 2011 indicates significant improvements in formal compliance with the FATF standards. In addition, exchange of information with other jurisdictions on tax and money laundering matters has also been stepped up, with the legislative framework now giving the Sammarinese authorities greater powers to collect and transmit information.

¹ MONEYVAL is the Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism of the Council of Europe.

Outlook

The short-term economic outlook remains weak. Under the baseline scenario staff projects that real GDP will decline by 3.5 percent in 2013, mainly due to a weakening demand for exports and continued adjustments in the financial sector. The recovery is expected to be gradual and likely tepid, in line with output development in Italy. Downside risks still dominate, mainly stemming from a lower than expected external demand. On the upside, a prompt ratification of the double taxation treaty by the Italian parliament would normalize the relations between the two countries and would pave the way for the ratification of other two arrangements (the *Financial Cooperation Agreement* and the *Economic Cooperation Agreement*) with positive effects on San Marino's economic and financial activity.

Fiscal Policy

Despite the deep economic contraction since the blow of the crisis, a combination of revenue and expenditure measures have helped to limit the deterioration of the fiscal balance, which has moved from a surplus of about 1½–3 percent of GDP in the years before the crisis to a projected deficit of 2.9 percent in 2012. Even if public debt has increased, it remains low at about 20 percent of GDP in 2012.

This notwithstanding, lingering uncertainty about future economic developments and the recapitalization needs of the main domestic bank (*Cassa di Risparmio della Repubblica di San Marino*) calls for the need to rebuild fiscal buffers in order to bolster the resilience of the economy to adverse shocks. The staff's Public Debt Sustainability Analysis shows that under the baseline scenario, which excludes additional bank recapitalization costs, debt would increase substantially, reaching slightly less than 40 percent of GDP in 2018. In order to anchor debt staff estimates that an additional correction of about 4-5 percent of GDP is needed.

The government is fully aware of the need to proceed with an ambitious fiscal consolidation plan and it is intentioned to front-load the adjustment. Backed by a broad consensus across the political spectrum, the government aims to reach a balance budget by 2014. This would imply a fiscal effort of about 3 percent of GDP. While the measures to be included in the fiscal consolidation package have yet to be decided, it is broadly recognized that there is ample room to achieve savings both on the expenditure and revenue side. The findings of the spending review to be concluded in the coming days will guide the choice of the appropriate spending cuts, while the tax reform offers a unique opportunity to broaden the narrow tax base.

Financial Sector

The process of recapitalization of the *Cassa di Risparmio della Repubblica di San Marino* (CRSM), biggest bank in the system whose assets accounted for 37 percent of the total in 2008, is ongoing. The state has directly or indirectly contributed €95 million (or 6.5 percent of the 2012 nominal GDP) out of €120 million in the recapitalization funds so

far. While the extent of Cassa di Risparmio's total losses on its Delta investment remains uncertain at this stage, more capital will be needed in order to comply with the prudential requirements and to serve the Sammarinese community from a position of strength.

The state is ready to cover the additional recapitalization need but it will impose stronger conditionality than in the past. In particular, the legal provision that protects the majority stake of the current bank's shareholders, a charitable foundation with roots dating to the 19th century, will be abrogated. With this reform the state will become the majority shareholder while the foundation will only retain a small (symbolic) share. Additional reforms will include a replacement of the bank's top management and of the board of directors. Regarding the modalities of the recapitalization, the government is working on a solution that would secure the liquidity of the CRSM and the stability of the banking system at large.

As regards the rest of the banking sector, over the past months pressures have eased. Deposits have stabilized or have increased modestly in some cases, contributing to improve bank liquidity positions. Also Delta resolution is boosting liquidity as CRSM's assets that were immobilized are slowly released and the bank has been able to repay loans outstanding to other banks. Nonetheless, there is not room for complacency; the recession is leading to mounting non-performing loans across all banks. Against this background, the central bank has intensified supervision in order to ensure that banks are provisioning adequate amounts against expected losses, and that they remain liquid and well capitalized.

Structural Reforms

Together with the spending review activities and the tax reform, San Marino is adopting a development plan aimed at reshaping its economic context in the near future. The decision to adopt a multifaceted economic structure has been confirmed, where tourism, trade, high value-added production, banking and financial sector are the key elements, together with the creation of a scientific and technological park connected with businesses and the university to develop research activities and promote innovative entrepreneurial initiatives.

The recovery plan is based on the internationalization of the country as a whole, a considerable reduction of the degree of discretion, the simplification and harmonization of laws, also by adopting single texts for specific sectors in order to provide a system more understandable from the outside. This plan also aims at attracting foreign investments on the basis of precise access criteria, reshaping public administration, adopting GRECO² legislation, reducing bureaucracy and computerizing public services.

Moreover, an infrastructural plan has been identified, which includes a new connection to the coast, the development of the international airport Rimini - San Marino focused on cargo, maintenance and business activities, water self-sufficiency and waste management, as well as strengthening of telecommunications as a key infrastructure supporting

² The Group of State against Corruption (GRECO) is the Council of Europe's anti-corruption monitoring body.

economic development. The disposal of non-strategic public corporations is also envisaged. Moreover, important infrastructural interventions are envisaged in favor of tourism, including the restructuring of many areas located in the historic centre and the creation of a museum centre.

Taxation will be used to attract investments and to enhance the competitiveness of existing businesses. This will not imply any scatter gun measures but rather a more favorable tax regime provided that investments in research, training and recapitalization are made. A package of incentives will be destined to new San Marino enterprises, in order to favor access by young and unemployed people to the labor market. From 2014, the VAT regime will be introduced according to different modalities based on the characteristics of each sector, in order to treat San Marino businesses operating on foreign markets on an equal footing. Also the labor market will be subject to interventions, in particular social safety nets and the professional training system will be reviewed. The banking and financial system is an important element supporting businesses.

The development plan includes interventions aimed at re-establishing mutual relations with Italy, access to the payment system in 2014, as urgent objectives, and the building of a legal framework, while respecting international rules, for the development of an international financial centre. A considerable strengthening of the university is envisaged and bilingualism has been identified as one of the objectives.