Statement by Domenico Fanizza, Executive Director for the Republic of San Marino, and Francesco Spadafora, Senior Advisor to Executive Director
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The authorities of the Republic of San Marino reiterate their appreciation for the candid and cooperative discussions held with Fund staff during the Article IV consultation and very much value their recommendations and tailored advice. The authorities broadly concur with the staff's analysis and will continue to rely on the Fund's recommendations to strengthen the ongoing recovery and safeguard financial stability and the soundness of public finances. They welcome the staff's recognition that their policy efforts have managed to lower the country's economic and financial vulnerabilities, despite the unprecedented adverse impact of the Covid-19 pandemic. On the back of a strong recovery underway, despite this year's large increase, the public debt-to-GDP ratio is now projected to be on a declining path starting in 2022—a noticeable turnaround compared to the 2020 assessment of debt sustainability.

The authorities responded to the pandemic in a timely and targeted way by adopting a comprehensive package of policies, focused on supporting the health sector and the most vulnerable share of the population; besides, easing of supervisory and prudential measures provided further relief to households and corporates by avoiding a contraction of credit supply. Labor markets have proven resilient, as the private sector quickly adopted measures that safeguarded employees' health. An effective vaccination campaign—which progressed at one of the fastest paces in Europe—laid the groundwork for a strong recovery.

Successful access to international capital markets in late 2020 and again in early 2021 boosted liquidity and allowed the authorities to step up their policy response with a supportive fiscal stance in 2021. In addition, the Central Bank of San Marino (CBSM) secured a €100 million bilateral swap line with the European Central Bank that, in the event, was not used. As recognized by staff, this policy response boosted confidence, improved macroeconomic and fiscal buffers, and provided much-needed support to the economy, which showed significant resilience. Consumption and manufacturing exports have now risen above their pre-pandemic levels; banking sector liquidity has increased to reach European average levels.

Economic growth has strongly rebounded—it is expected at 5.5 percent this year—supported by external demand, pent-up consumption and investment, and policies that will continue to benefit employment. Inflation has remained low, and macroeconomic and fiscal stability has benefited from a recovery of confidence. The authorities expect output to reach its pre-pandemic level over the next few months, with little scarring, stable unemployment, and bankruptcies limited to less than 1 percent of firms. Against this favorable background, the authorities have already started to gradually unwind emergency support, while keeping some targeted measures in place.

The authorities broadly agree with the staff's assessment of the outlook and risks but believe that growth this year could surprise on the upside, in light of the resilience of the manufacturing sector, the strength of the vaccination campaign, and the recent opening of a large shopping mall.

The authorities agree that comprehensive fiscal reforms are needed to further enhance economic sustainability, counter the increase in public debt and lower rollover risks; they also emphasize that important reforms already implemented in the financial sector can further boost confidence; they note that San Marino's Eurobond's valuation has strengthened since its issuance, with spreads compressing beyond those of peers. Finally, the authorities remain committed to pursuing structural reforms to lift the economy's growth potential by increasing its attractiveness vis-à-vis foreign investors; they remain confident that the negotiations on the EU accession agreement can be completed in the next year and a half.

Fiscal Policy

Despite pre-existing constraints, fiscal support played a critical role in mitigating the impact of the pandemic. On the revenue side, the authorities approved tax deferrals, allowed the rescheduling of income tax payments and utility bills, and granted tax credits and tax cuts. A temporary solidarity levy applied on pensions above €1,500 was also introduced. On the spending side, there was a freeze to all non-essential spending, while savings from the temporary reduction in public sector wages were allocated to the healthcare sector. A minimum guaranteed income was introduced to protect poorer households and the supplemental wage scheme extended to support workers who were affected by the lockdown; this scheme helped cushion the effect on employment, which declined only by 1.5 percent, and has recovered since.

The fiscal response was substantially scaled up after securing external borrowing and government deposits increased. After many years contemplating access to international markets, a one-year bridge loan was secured in December 2020 from Cargill Financial Services for €150 million at a 2.95 percent interest rate. Additionally, in February 2021, San Marino successfully issued its first Eurobond for €340 million at a 3.25 percent interest rate and 3-year maturity.

The government has used the proceeds from the Eurobond to retire existing government debt owned by the state-owned bank Cassa di Risparmio di San Marino (CRSM) and to repay a loan granted by CBSM, for a total of €149 million, and plans to repay the bridge loan. The remaining resources will be used to finance the 2021 budget and repay short-term external debt.

The inflow of external liquidity allowed the authorities to unlock expenditure envisaged in the 2020 budget, loosening the fiscal stance from close to balance in mid-December to -3.5 percent of GDP at end-2020. The government adopted new targeted support measures earlier this year—including guarantees for firms that had lost at least 30 percent revenue in 2020—for a total of about 1 percent of GDP.

The authorities are aware of the importance of achieving higher liquidity buffers and agree that the fiscal position should be strengthened to ensure fiscal sustainability, given this year's increase in the public debt-to-GDP ratio. To this end, they are working on important growth-friendly fiscal reforms that include: (i) rationalization of direct taxes; (ii) the introduction of a VAT; and (iii) the rationalization of social benefits. Furthermore,

an ambitious reform to restore the financial equilibrium of the pension system is under discussion.

Financial Sector

External borrowing allowed San Marino to boost the liquidity of the banking system and safeguard financial stability. The government increased deposits at the CBSM and, as noted before, repaid an existing loan from it – increasing international reserves – and a bond held by CRSM.

Supervisory and prudential measures supported credit and provided further relief to both households and corporates. The government adopted a payment moratorium generally in line with European Banking Authority's guidelines for amortization of loans until March 2021; guarantees were issued on loans to households at risk and firms in the tourism sector. To boost their capital, banks were allowed to irreversibly reclassify securities from the trading to the banking book at market prices as of end-January 2020.

As a result of the comprehensive policy measures, system-wide bank deposits – also helped by pandemic-driven private savings – remained broadly stable in 2020 and have grown this year at the fastest pace since the Global Financial Crisis (GFC). At the same time, nonfinancial sector deposits' abroad (around 15 percent of San Marino banks' total deposits) have increased at an even faster pace.

The banking system has been rationalized, its capitalization strengthened, and liquidity substantially improved.

The capital position of CRSM was boosted with a sovereign perpetual bond (€455 million with a 1.75 percent interest rate) to cover post-GFC losses. Two private banks are being recapitalized by shareholders after improving provisioning in line with the results of the 2017 Asset Quality Review. The banking system was further consolidated with the revocation of the license of Banca Nazionale di San Marino (BNS), a bank created after the resolution of Banca CIS in 2019.

A law establishing an asset management company (AMC) was approved in August 2021 to tackle high system-wide NPLs. The authorities underscore that they intend to minimize fiscal risks associated with guarantees issued to the AMC and are considering measures aimed at aligning the potential positive impact on banks' capital to the effective de-risking that the transfer of assets could involve.

The authorities agree that preserving appropriate levels of banks' liquidity is a key priority. However, they are concerned that high reserve requirements could unduly impact banks' profitability and would favor instead complementary measures such as supervisory expectations on banks' liquidity buffers. They also highlighted how more aggressive steps towards Basel III, including booking provisions based on IFRS9's forward looking approach, are constrained by the current version of the Monetary Agreement with the EU, refers to pre-IAS/IFRS.

Important steps have also been taken to improve the efficiency of the banking system—driven by significant efforts at CRSM. Costs have been strongly reduced, but there is still ground for improvement. Personnel costs fell by 30 percent in the four years up to 2020

and are expected to fall further in 2021. These savings reflect a reduction of staff while wages have remained at pre-GFC levels, governed by a 10-year-old expired but still binding collective agreement. During the same period, the branch network was consolidated by more than 40 percent, but it remains high by regional standards.

The authorities emphasize that there has been significant progress in improving the AML/CFT framework, as demonstrated by the recent MONEYVAL assessment that points to satisfying levels of effectiveness in relation to risk understanding, financial intelligence, confiscation, and terrorist financing prosecutions and high level of effectiveness in relation to international cooperation. San Marino completed the second national risk assessment in 2019, which led to a strategy implemented in 2020. The authorities are also addressing the remaining challenges through implementation of the EU AML/CFT Directives.

Structural Reforms

The authorities remain committed to tackling structural impediments to faster growth and agree on the need to continue pursuing structural reforms to increase the economy's attractiveness to investors.

Work is underway on a comprehensive reform of the labor market to further increase flexibility by liberalizing restrictions on hiring and enhancing training for the unemployed to match firms' skill needs.

The business environment will benefit from the ambitious agenda of "San Marino 2030" to reduce bureaucracy, simplify the legal framework, and foster digitalization and internationalization; the agenda also envisages public investments through public-private partnerships. Investment in education and legal reforms to improve enforcement of dispute resolutions are also underway.