INTERNATIONAL MONETARY FUND

IMF Country Report No. [22/349]

REPUBLIC OF SAN MARINO

2022 ARTICLE IV CONSULTATION—PRESS RELEASE AND STAFF REPORT

November 2022

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 2022 Article IV consultation with the Republic of San Marino, the following documents have been released and are included in this package:

- A **Press Release**.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on a lapse-of-time basis, following discussions that ended on October 7, 2022, with the officials of the Republic of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 1, 2022.
- An **Informational Annex** prepared by the IMF staff.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Copies of this report are available to the public from

International Monetary Fund • Publication Services
PO Box 92780 • Washington, D.C. 20090
Telephone: (202) 623-7430 • Fax: (202) 623-7201
E-mail: publications@imf.org Web: http://www.imf.org
Price: $18.00 per printed copy

International Monetary Fund
Washington, D.C.

IMF Executive Board Concludes 2022 Article IV Consultation with the Republic of San Marino

FOR IMMEDIATE RELEASE

Washington, DC – November 23, 2022: On November 21, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino and considered and endorsed the staff appraisal without a meeting.

San Marino's economy has been remarkably resilient over the last two years. After Russia's invasion of Ukraine, San Marino faced an unprecedented energy price shock which, compounded with a food price shock, led to high inflation and real income erosion. However, the strong external demand amidst global supply chain constraints and an elevated inflow of tourists have boosted economic activity. GDP is estimated to have grown by 8.3 percent in 2021 and 3.5 percent in 2022. The strength of the manufacturing sector has been a key source of resilience.

The energy shock has been milder than in neighboring countries as San Marino secured beneficial energy import prices this year and next, that have resulted in tariffs below regional peers at minimal fiscal costs. At the same time, the authorities have allowed price signals to guide demand, while minimizing the disruptive economic impact and supporting vulnerable groups. Despite a strong recovery and the withdrawal of covid-related support, the fiscal position remains weaker than before the pandemic largely due to ageing-related spending pressures. Meanwhile, banks' capitalization and profitability improved in 2021, while deposits grew. However significant challenges remain given very large nonperforming assets and weak capitalization.

Macroeconomic risks to the economy are significant, including high energy prices and further disruptions to energy supply, tightening financial conditions, and growing global uncertainty. Therefore, it is key to build fiscal and financial buffers, while accelerating the reform agenda. With elevated public debt and the large Eurobond rollover in 2024, an ambitious fiscal consolidation is needed to ensure sustainability and reduce risks. In this connection, the approval of pension reform expected this year and income tax reform next year are key and cannot be delayed. With likely higher-for-longer interest rates and energy prices, the banking system enters a stage of new challenges. Thus, there is a need to strengthen capital, improve banks' efficiency and accelerate the reduction of nonperforming loans avoiding fiscal risks and forbearance. Finally, reforms that preserve and support macroeconomic stability should be complemented with structural reforms needed to boost long-term growth.

[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.

Executive Board Assessment[2]

With higher energy prices, tightening financial conditions, and growing global uncertainty, activity is expected to slow down. Therefore, the priority should be to build fiscal and financial buffers, while accelerating the reform agenda. The rollover of the Eurobond maturing in 2024 remains a risk.

The authorities' response to high energy inflation allows price signals to operate and supports vulnerable groups. A combination of a long-term gas contract and timely electricity hedging operations, just before prices surged has allowed to adjust tariffs to cost recovery levels but well below neighboring countries. This was done at minimum fiscal costs and avoiding the potentially disruptive macroeconomic impact associated with large tariff increases. Plans to pass-through import energy prices to consumers next year will continue to avoid fiscal costs and preserve the financial soundness of the state-owned utility company.

Increasing global interest rates, elevated public debt, and the pending Eurobond roll-over, call for an ambitious fiscal adjustment notwithstanding weakening economic activity. With increased global financial uncertainty, the authorities should opportunistically rollover the Eurobond starting early next year whenever market conditions are favorable. Given the deteriorating outlook, the authorities should save revenue over-performance this year to build up government deposits while resisting spending pressures. Going forward, strengthening the fiscal position will require a fiscal adjustment by the central government of 2 percent of GDP over the next three years to reach a central government primary balance of 2.5 percent of GDP complemented by pension reform. In particular,

- Revenues: The proposed income tax law amendments should be promptly approved and be more ambitious in reducing exemptions and loopholes. Introduce the VAT.

- Spending: Public sector wage and pension increase in line with recently agreed private sector collective bargaining agreements could contain expenditure permanently and support the needed fiscal consolidation in the near term.

- Pensions: The proposed pension reform stabilizes the system's deficit over the next decade, but further recalibration of pension spending will be needed to ensure long-term sustainability. The approval of this reform cannot be delayed given increasing deficits of the Social Security.

There is a need to develop a comprehensive debt management strategy that will support debt sustainability and help develop a domestic debt market over the medium-term. With limited fiscal space, San Marino needs a strong, medium-term debt management framework that increases predictability. In this context, the conversion of ex-BNS uninsured depositors' bonds will help develop the domestic debt market and reduce the burden on taxpayers.

Banks' profitability and capitalization have improved, but significant challenges remain. With extraordinarily high NPLs and the recent halt of efficiency improvements, profitability remains

---

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

limited and fragile. In the context of falling bond valuations, new pressures on the capital base have arisen. The plan to transparently report the transfer of assets from the trading to the investment portfolio that is held until maturity is welcome.

The implementation of the strategy to reduce NPLs should not be delayed further. The delays have postponed banks own NPL resolution. If NPLs are found to have a real economic value below the net book value, their transfer should transparently result in a reduction of capital ratios. Any undercapitalization that could arise should be promptly addressed with credible capitalization plans. There should be a clear incentive structure for most NPLs to be transferred and NPLs remaining in banks' books should be subject to calendar provisioning following European standards.

In a euroized economy without independent monetary policy, preserving healthy levels of financial sector liquid buffers is key to preserve stability and confidence. This is more so given the limited tools available to absorb shocks, heightened international uncertainty and increased volatility in financial markets. As expected, international reserves have fallen as banks deposits at CBSM moved abroad to take advantage of higher rates, a trend that is expected to continue in the near term.

San Marino should continue to make progress in strengthening the implementation of the AML/CFT framework. Efforts to transpose the EU AML directive into the domestic legal framework are welcome but should be expedited.

Reforms that preserve and support macroeconomic stability should be complemented with structural reforms needed to boost long-term growth. Progress towards the EU association agreement and the labor market reform are welcome but should be completed and implemented. In particular, labor market reform should make permanent the recent liberalization of cross-border workers and increase flexibility of temporary employment. Plans to improve the business climate are critical and further efforts are needed to improve an outdated insolvency framework.

San Marino: Selected Economic Indicators, 2017–22

	2017	2018	2019	2020	Est. 2021	Proj. 2022
Activity and Prices						
Real GDP (percent change)	0.3	1.5	2.1	-6.7	8.3	3.5
Unemployment rate (average; percent)	8.1	8.0	7.7	7.3	5.8	5.4
Inflation rate (average; percent)	1.0	1.8	1.0	0.2	2.1	6.9
Public Finances (percent of GDP) 1/						
Revenues	22.1	23.0	22.3	21.6	21.9	21.5
Expenditure	25.6	24.5	22.4	59.2	39.4	24.8
Overall balance	-3.5	-1.6	-0.1	-37.6	-17.4	-3.3
Government debt (Official)	21.6	30.1	25.9	71.6	66.9	69.0
Public debt 2/	56.7	57.2	57.4	71.6	86.3	83.7
Money and Credit						
Deposits (percent change)	3.3	1.3	-5.7	8.6	8.6	...
Private sector credit (percent change)	0.9	-6.7	1.0	-4.1	-10.8	...
Net foreign assets (percent of GDP)	137.9	124.8	123.5	130.7	145.8	...
External Accounts (percent of GDP)						
Current account balance	-0.4	-1.9	2.0	2.8	4.5	1.3
Gross international reserves (millions of euros)	252.7	248.1	410.6	636.8	844.1	652.1
Financial Soundness Indicators (percent) 3/						
Regulatory capital to risk-weighted assets	13.7	12.3	9.5	10.7	14.4	...
NPL ratio	51.6	50.7	58.9	61.1	59.0	...
NPL coverage ratio	56.0	58.2	63.6	64.4	65.0	...
Return on equity (ROE)	-10.3	-17.2	-74.6	-7.7	3.8	...
Liquid assets to total assets	15.7	15.2	18.0	19.2	27.3	...
Liquid assets to short-term liabilities	28.3	27.6	32.7	33.1	44.0	...

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

1/ For the central government.

2/ Central government (official) debt plus Social Security Fund and BNS debt.

3/ 2017–18 data do not reflect 2017 AQR results, while 2019 data reflect changes related to Banca CIS resolution.

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2022 ARTICLE IV CONSULTATION

November 1, 2022

KEY ISSUES

Context. San Marino's economic activity showed remarkable resilience throughout the pandemic. After Russia's invasion of Ukraine, San Marino faced an unprecedented energy price shock which, compounded with a food price shock, led to high inflation and real income erosion. However, strong external demand amidst global supply chain constraints and an elevated inflow of tourists have boosted economic activity so far this year. At the same time, San Marino secured beneficial energy import prices this year and next that have resulted in tariffs below regional peers at minimal fiscal costs. Despite a strong economy, the fiscal position in 2021 remained relatively weak. However, greater reliance on domestic debt along with a large share of long maturing and low interest debt is supporting favorable debt dynamics given higher inflation. Banks' capitalization and profitability improved in 2021, deposits continued to grow, while credit contracted. Progress halted recently while vulnerabilities remain given very large nonperforming assets and weak capitalization.

Outlook and risks. With increasing uncertainty and a weakening global environment, economic activity is expected to decelerate markedly at the end of 2022, breaking the recent strong growth momentum. The current account surplus and international reserves will deteriorate as the economy adjusts to the negative terms of trade shock. The fiscal position, set to improve due to the withdrawal of covid-related support, will, in the absence of fiscal adjustment, remain weaker than what is needed to put fiscal accounts and debt sustainability on a strong footing. Downside risks related to Russia's invasion of Ukraine continue to dominate the outlook. Given large public gross financing needs, the rollover of the Eurobond in early 2024 remains a key risk.

Policy discussions. The main priority is to mitigate risks and proactively minimize the impact of global uncertainty. In this regard, energy tariffs should be adjusted to reflect higher import prices while temporarily protecting vulnerable consumers. More broadly, the economy needs to strengthen its fiscal position to ensure sustainability and preserve buffers by implementing revenue, expenditure, and pension reforms in the context of a medium-term fiscal and debt management strategy. On the financial sector, there is a need to strengthen capital, improve banks' efficiency and accelerate the reduction of nonperforming loans avoiding fiscal risks and forbearance. Finally, structural reforms to increase the flexibility of the labor market and efforts to advance the EU's association agreement are critical to increase the flexibility of the economy and preserve macroeconomic stability in a euroized economy.

Approved By	
Helge Berger (EUR) and Anna Ilyina (SPR)	Discussions were held on September 27–October 7, 2022, in San Marino. The team comprised Mr. Gracia (head), Ms. Agrawal, and Messrs. Cabezon and Tolosa (all EUR). Mr. Spadafora (OED) participated in the discussions. The team met with the Heads of State, Secretaries of State for Finance and Budget, Foreign Affairs, Internal Affairs, Industry, Health and Social Security, Tourism and Territory and Environment, Central Bank President, other cabinet members and central bank officials, private sector representatives, and social partners. Mses. Burova, Fisher, Gamboa Gonzalez, Jung, and Noren, and Mr. Velazquez-Romero (all EUR) assisted the mission from headquarters.

CONTENTS

CONTEXT: RESILIENCE AMONG FRAGILITY AND A WORSENING EXTERNAL ENVIRONMENT 4

RECENT DEVELOPMENTS: STRONG ECONOMIC MOMENTUM JEOPARDIZED BY WAR 4

OUTLOOK AND RISKS 11

POLICY DISCUSSIONS: STRENGTHEN THE FRAMEWORK TO COPE WITH SHOCKS 13

A. Response to High Energy Prices and the Climate Challenge 13

B. Fiscal Reforms to Set the Basis for a Sustainable Fiscal Position 14

C. Reforms to Strengthen the Banking System 17

D. Implement Structural Reforms to Support Private Sector-Led Growth 19

STAFF APPRAISAL 19

BOXES

1. Autonomous State Agency for Public Services 6
2. Collective Wage Bargaining Agreement 2021–23 7
3. Income Tax Amendments 15
4. Key Elements of the Pension Reform Under Parliamentary Discussion 16

FIGURES

1. Macroeconomic Developments 22
2. High Frequency Indicators 23
3. Fiscal Developments 24
4. Monetary and Banking Developments 25

TABLES

1. Selected Economic and Social Indicators, 2019–27 ____ 27
2a. Statement of Operations for Budgetary Central Government, 2019–27 (Millions of euros) ____ 28
2b. Statement of Operations for Budgetary Central Government, 2019–27 (Percent of GDP) ____ 29
3. Balance of Payments, 2019–27 ____ 30
4. Financial Soundness Indicators, 2016–22 ____ 30
5. Depository Corporations Survey, 2016–21 ____ 31

ANNEXES

I. Risk Assessment Matrix ____ 32
II. Authorities' Response to Past IMF Recommendations ____ 33
III. External Sector Assessment ____ 34
IV. Debt Sustainability Analysis ____ 38
V. Post-COVID Labor Market Rebound and Trends ____ 50
VI. Improving Public Debt Management ____ 52