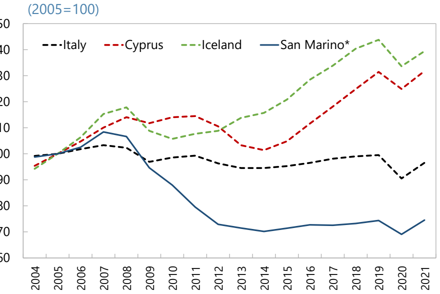
CONTEXT: RESILIENCE AMONG FRAGILITY AND A WORSENING EXTERNAL ENVIRONMENT

1. **San Marino's economy has been remarkably resilient post-pandemic.** However, real income remains well below pre-Global Financial Crisis levels lagging significantly behind other economies that also suffered a banking crisis. The economy has been systematically affected by neighboring Italy's lackluster performance, but it has also been hampered by problems of its own, with persistent challenges in the banking system and pressing structural constraints.

Real GDP
(2005=100)



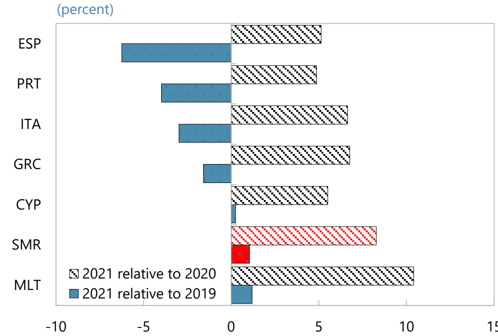
*2021 Estimates.
Source: Haver Analytics, Sammarinese authorities and IMF staff.

2. **Access to international capital markets in early 2021 increased policy and macroeconomic buffers to healthy levels boosting confidence.** San Marino entered the pandemic with long-standing vulnerabilities, including low policy and macroeconomic buffers. However, major disruptions were avoided after accessing international capital markets and the fallout from the pandemic was in line with regional comparators. With Russia's invasion of Ukraine, the economy braces itself to feel the full brunt of the shock to food and fuel prices, tightening financial conditions and increasing global uncertainty.

RECENT DEVELOPMENTS: STRONG ECONOMIC MOMENTUM JEOPARDIZED BY WAR

3. **The economy has surpassed pre-pandemic levels, as the rebound was followed by a strong momentum.** Growth, projected at 8.3 percent for 2021, continued its strong performance until August 2022. Policies leading to higher liquidity buffers, an improved banking sector and the prospects of structural reform supported confidence. The lifting of mobility restrictions facilitated demand from tourists, while enabling external conditions boosted investment and exports. Manufacturing production showed significant strength as a strong fiscal stimulus in Italy and trade disruptions with Asia provided an unprecedented demand for goods produced regionally.

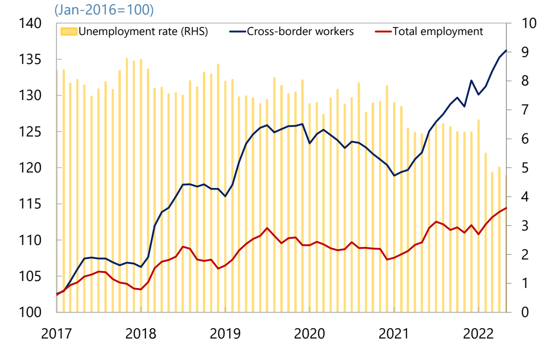
Real GDP Growth
(percent)



Sources: Sammarinese authorities, Haver and IMF staff.

4. Labor market outcomes have been the best in over a decade amid rapid firm creation. Employment reached the highest level since 2012, with the unemployment rate falling to 5.3 percent by mid-2022, to the point that restrictions imposed during covid to protect local employment were lifted in July. Employment growth was led by manufacturing and retail, more than compensating for the job-shedding in the financial sector and construction.

Employment and Cross Border Workers
(Jan-2016=100)



Sources: Sammarinese authorities and IMF staff estimates.

5. San Marino faces an unprecedented energy price shock particularly after Russia's invasion of Ukraine, albeit milder than neighbors.[1] Higher imported price of energy prompted the regulatory authority to grant the public energy utility company (AASS) increased gas and electricity tariffs:

- ***For electricity***, a retail price increase of 25–40 percent at the beginning of the year accommodated part of the import price shock. This represented less than half the increase in Italy's regulated market because late last year San Marino secured an early lock-in of prices for the year in the wholesale futures market. In March this year, they repeated a similar operation and hedged prices for 2023 significantly below recent market levels.

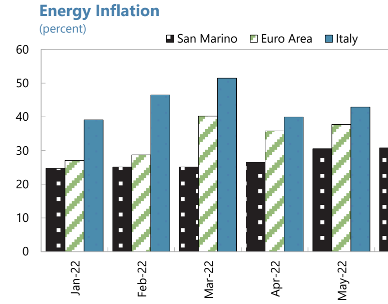
- ***For gas,*** import price increases were also more limited as a six-year import contract with Enel fixed prices at around €44 per MWh for 45 MW of supply at end-February. Nevertheless, the energy component of gas tariffs increased between 70–150 percent.

San Marino: Tariff Adjustments[1]
(Percent)

	Since Jan. 1, 2022	Since July 1, 2022	**Year to day**
Natural Gas			
Households	30	30	**69**
Industrial primary	36-46	81	**157**
Industrial secondary	30	35	**76**
Electricity	4/		
Households (low consumption)	25	0	**25**
Households (high consumption)	35	0	**35**
Others	40	0	**40**

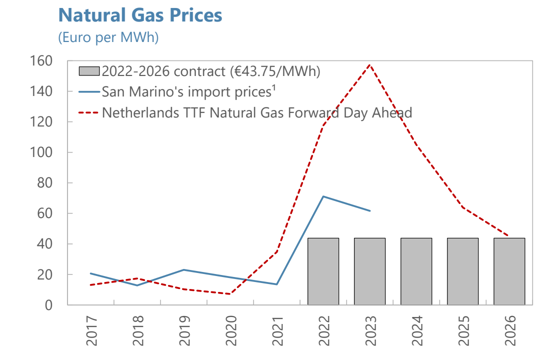
Source: San Marino Regulatory Authority for Public Services
1/ Referes to energy component of overall tariffs.

Energy Inflation
(percent)

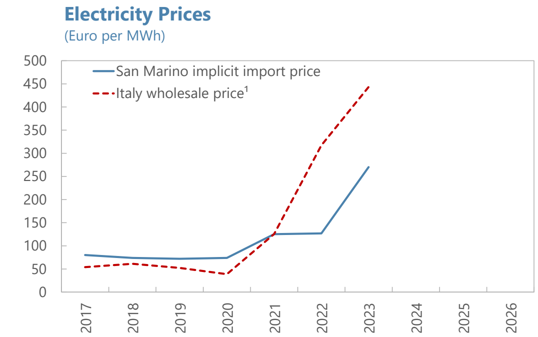


Sources: Sammarinese authorities, Haver, and IMF staff estimates.

[1] San Marino has imposed sanctions on Russia, including the central bank and selected banks following the list of EU sanctions adopted after Russia's invasion of Ukraine available on the EU website. Some of these sanctions may constitute capital flow management measures. Analysis of the global spillovers of sanctions can be found in April 2022 World Economic Outlook.



¹The price is higher than thecontract as the contract covers 80 percent of consumption.
Sources: Sammarinese authorities, and IMF staff estimates.



¹ 2022 reflects Jan-Oct and 2023 corresponds to futures market as end Sep. 30, 2022.
Sources: Sammarinese authorities, GME, and IMF staff estimates.

6. The authorities provided support to limit the fallout, including to the most vulnerable. The regulatory authority did not approve the full increase requested by AASS, reducing large pre-crisis profits from electricity and gas distribution. In the case of gas, there were also temporary losses associated with high prices paid at the spot market before the new contract was signed and a delay in the second tariff adjustment until June. As AASS engages in other loss-making activities (see Box 1), the total loss will be around 0.6 percent of GDP in 2022. To limit price increases to the most vulnerable, tariff increases were differentiated for households relative to firms, and according to installed capacity and level of consumption. Also, a targeted compensation consisting of subsidies and payment delays was approved at an estimated cost of 0.1 percent of GDP.

Box 1. Autonomous State Agency for Public Services

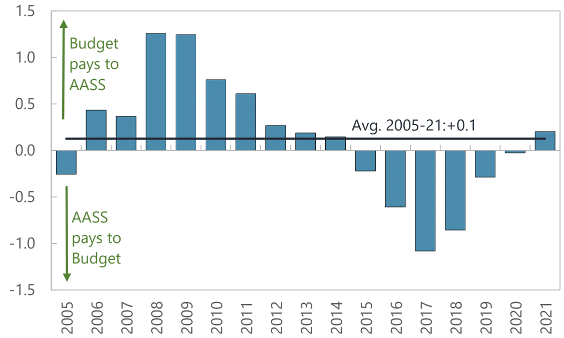
AASS, a state-owned enterprise, supplies public services that include electricity, natural gas, water distributions, sewerage, garbage collection, urban hygiene, and public transportation. The company also engages in energy trading to stabilize domestic prices.

While energy distribution and trading have generated profits, other services have carried systematic losses. Thus, budget transfers have been minor over the last 7 years as large profits since 2015 have allowed AASS to build significant liquid buffers, reaching €52 million in May 2022 or 3.3 percent of GDP.

Gas: The tariff adjustments should ensure profits in gas distribution until 2027, although residual risks remain given that the contract quantity cap, around 80 percent of average past consumption, may not cover all consumption during winter. Thus, losses in 2022 due to spot market purchases before the contract was signed are expected to be temporary.

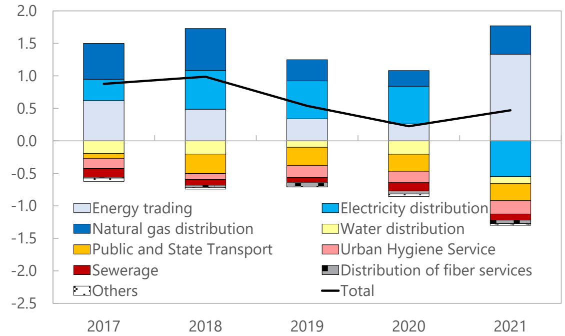
Electricity: After finalizing a new contract in March this year, the hedging for purchases covers this year and next at prices significantly below current market levels. Thus, a hike in tariffs of around 50 percent will be required to ensure cost recovery at AASS. With these operations and given current market prices, losses around 4-5 percent of GDP for the economy have been avoided.

Budget Tranfers to AASS
(Percent of GDP)



Sources: Country Authorities and IMF Staff estimates.

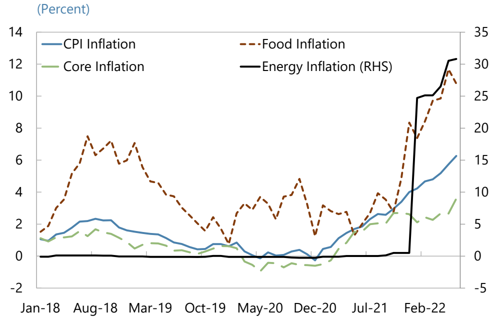
AASS: Profits by Service
(Percent of GDP)



Sources: Country authorities; and IMF staff estimates.

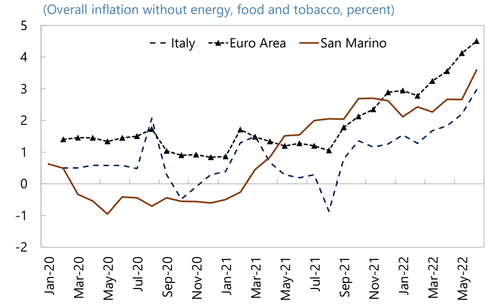
7. **Inflation second-round effects have been moderate.** With a food price shock compounding the energy shock, headline inflation reached 6 percent in June. Core inflation is on an upward trajectory since the second half of 2021 but remains below 3 percent, lower than in the Euro Area. Nominal wage growth has been constrained (see Box 2), with labor market tightness eased by a very elastic supply of cross-border workers.

Inflation
(Percent)



Sources: Sammarinese authorities, and IMF staff estimates.

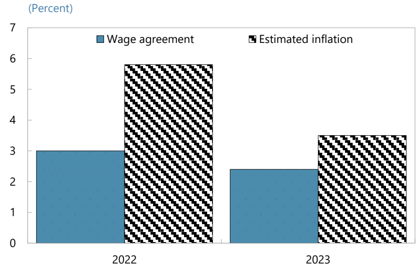
Core Inflation
(Overall inflation without energy, food and tobacco, percent)



Sources: Sammarinese authorities, Haver, and IMF staff estimates.

Box 2. Collective Wage Bargaining Agreement 2021–23

Wage Agreement 2022-23
(Percent)



Sources: IMF staff estimates.

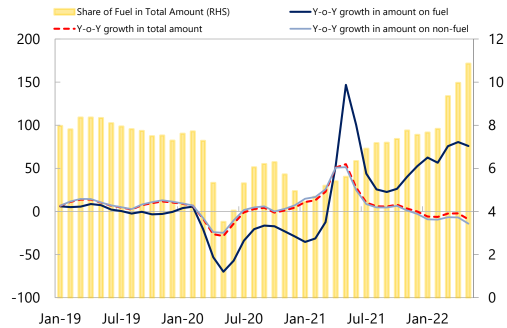
Wage contracts are governed by collective agreement renewed every three years but that remain valid if a new one is not reached (the banking system operates under the 2007 agreement).

In April 2021, the trade associations UNAS and OSLA, the national industrial association ANIS, and three trade unions Csdl, Cdls and USL signed a collective wage agreement, ratified by workers, for 2022 and 2023 encompassing 6,500 workers of the industrial sector representing one third of private sector employment.

The contract provided for an increase in wages of 5.4 percent over 2022-23 (1.5 percent from 1 June 2022, 1.5 percent from 1 August 2022, and 2.4 percent from January 2023). This is in addition to 0.6 percent wage increase in 2021 adding up to a total increase of 6 percent over three years. The craft sector (800 workers) had agreed to a similar contract last year.

8. Inflation eroded real incomes, weakening residents' consumption. Increased energy imports early in the year represented a negative terms of trade shock with an annualized impact of around 5 percent of GDP. Real income erosion has caused non-fuel consumption[2] to fall by 10 percent in first half of 2022.

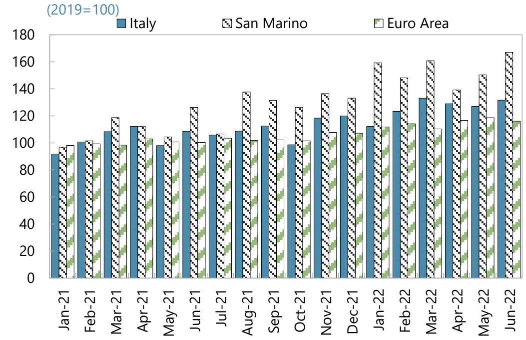
Retail Sales to Residents
(Percent)



Source: Sammarinese authorities and IMF staff estimates.

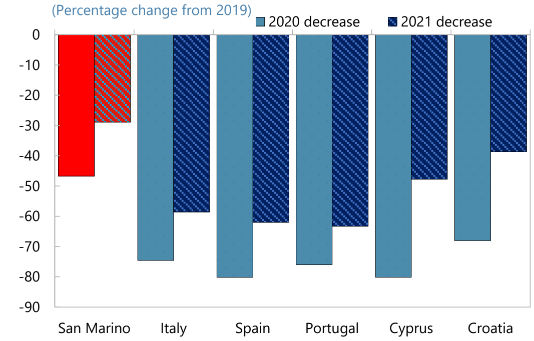
9. However, the external sector represented a key engine of growth. Manufacturing exports are now 55 percent higher, in nominal terms, than pre-pandemic levels, as supply chain constraints in Asian trade-competitors, higher transportation costs, and a robust Italian economy increased demand. Tourist arrivals in San Marino in 2021 rebounded sharply (supporting overall consumption despite the fall in that of residents), as restrictions were lifted on the back of a rapid vaccination campaign. The direct impact of the war has been very limited, as direct exposure to Russia and Ukraine is minimal.

Manufacturing Exports
(2019=100)



Sources: Sammarinese authorities and Haver.

Foreign Tourist Arrivals, 2020-21
(Percentage change from 2019)



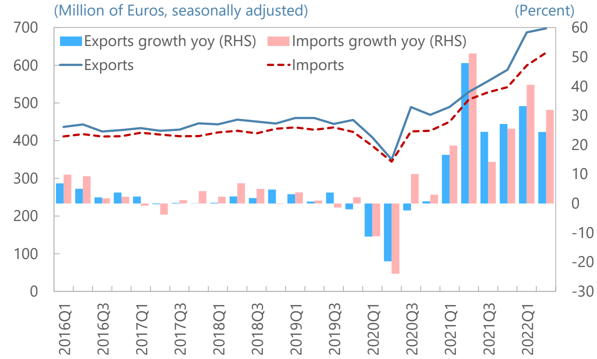
Sources: Haver Analytics; and IMF staff estimates.

10. The strength of exports has supported a significant current account surplus, but higher energy prices are starting to erode it. About half the increase in exports and imports is linked to prices. Raising energy prices play a key role in the increase of energy imports. At the same time, higher global interest rates are expected to positively impact the current account as San Marino has a large positive net investment position. At end-2021, international reserves were high by historical standards after very high levels at end-2021 at €843 million (57 percent of GDP) and were close to the optimal level.[3] However, by May 2022, international reserves declined to €651 million as banks have reduced deposits at the Central Bank of San Marino (CBSM), lured by the emergence of positive rates elsewhere in Europe.

[2] As measured by use of SMAC cards that residents hold.

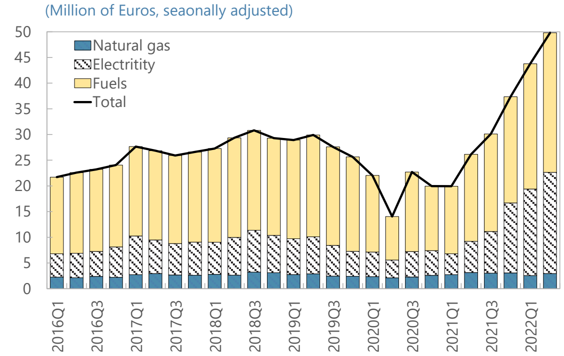
[3] See Annex III of Republic of San Marino: 2019 Article IV Consultation Staff Report.

Goods Foreign Trade
(Million of Euros, seasonally adjusted)



Sources: Country authorities, and IMF staff estimates.

Imports of Energy
(Million of Euros, seasonally adjusted)



Sources: Istat; San Marino Statistics office; and IMF staff estimates.

11. Despite a strong recovery and a tight labor market, the fiscal position remains weaker than before the pandemic. In 2021, the primary balance (net of bank support) reached -2.3 percent of GDP, significantly worse than the 2010–19 average of -0.3 percent of GDP. However, fiscal outcomes were significantly better than expected as the strong recovery and prudent policies resulted in lower covid-related spending. This led the authorities to accelerate transfers owed to the pension fund from previous years (2 percent of GDP) scheduled over the next 9 years.

12. The primary balance net of banks support and one-offs is projected to improve by 0.6 percent of GDP in 2022, supported by strong economic activity and high inflation. The indexation of spending including wages, done at the time of the approval of the budget last year, was significantly below current inflation levels. Exceptionally higher-than-expected tax revenues (by 1.5 percent of GDP) accommodated temporary energy-related spending (0.5 percent of GDP) and a one-off purchase of office space already rented for official use (1 percent of GDP).

Central Government: Selected Fiscal Indicators, 2019-22
(Percent of GDP)

	2019	2020	Est. 2021	1st Budget 2022	Proj. 2022
Revenues	22.3	21.6	21.9	20.0	21.5
Tax revenue	16.1	14.5	17.0	16.0	17.2
Nontax revenue	6.2	7.1	4.9	4.0	4.3
Expenditures	22.4	59.2	39.4	23.4	24.8
Primary expenditure expenses net of bank support	19.8	22.4	24.2	21.1	22.7
Interest payments	0.3	1.0	2.0	1.7	1.5
Bank support	2.3	35.8	13.1	0.6	0.6
Overall balance	-0.1	-37.6	-17.4	-3.4	-3.3
Primary balance net of bank support	**2.6**	**-0.8**	**-2.3**	**-1.7**	**-1.2**
Primary balance net of bank support and one-offs[1]	-0.6	-3.0	-1.8	-1.7	-1.2
Public debt[2]	57.4	71.6	85.1	...	83.7

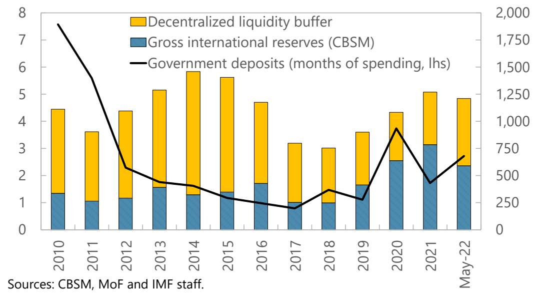
Sources: IMF staff estimates.
[1] One-offs include exeptional revenues and expenses.
[2] Debt statistics have been corrected for 2015-21 (See Annex IV for details).

13. The government has relied on domestic debt for funding, increasing diversification and preserving liquid buffers. After a very large external emission in 2021, the government relied on domestic funding in 2022 by issuing one-year bonds for €50 million—of which €20 million were purchased by the pension fund and the rest by banks—and planning to take loans for €20 million from domestic banks. After amortizing €74 million, cash balances remain unchanged above 2 months of spending. In addition, the government has preserved liquidity by converting €55 million of short-term government-guaranteed BNS IOUs (provided at the time of the bank's failure as compensation to uninsured depositors) into government long-term bonds—with a 17 percent haircut in present value terms.

Government Funding 2022

(Millions of euros)

Financing needs	**126**
Primary Deficit	28
Interest Payments	24
Amortization	74
o.w BNS bond	55
Financing Sources	**126**
Loans-Banks	20
Domestic bonds	104
Short term (Market)	50
Long term: BNS bond conversion	54
Asset recovery and other financing	9
Deposits (-=accumulation)	-7



Sources: CBSM, MoF and IMF staff.
Note: Decentralized liquidity buffer includes cash, deposits and loans available within 7 days, and securities that can be readily converted to cash but does not include deposits at CBSM and Sammarinese banks.

14. **Debt dynamics this year and next will be favorable, supported by higher GDP deflator inflation and the large share of nominal, low interest, long-maturing debt.** With funding needs already covered, and in the context of high nominal GDP growth, debt-to-GDP is projected to marginally fall this year for the first time since 2017 to 84 percent. Based on present expenditure policies, the positive impact of GDP-inflation on debt dynamics is projected to outweigh the medium-term negative impact of higher interest payments. Indeed, with long maturities and only 8 percent of public debt with variable interest rate at end-2021, debt is largely insensitive to interest rate volatility (see table).

Government and BNS Bonds

	Outstanding July 2022 (Percent of GDP)	Present Value[1] July 2022 (Percent of GDP)	Interest rate (Percent)	Original maturity (Years)	Residual maturity (Years)
Total Bonds (I+II)	**72.7**	**54.7**			
I. External bonds	**21.5**	**21.4**			
Eurobond 2024	21.5	21.4	3.25	3	1
II. Domestic bonds (a+b)	**51.2**	**33.4**			
a. Market bonds	**11.9**	**10.9**			
Bond 2026 (DD n.17/2016)	2.5	2.6	Euribor+1.5[2]	10	3
Bond 2026 (DD n.55/2016)	0.6	0.6	Euribor+1.5[2]	10	4
Bond 2029 (DD n.153/2019)	2.1	2.0	2.00	10	7
Bond 2023 (DD n.61/2022)	3.2	3.1	0.80	1	1
Bond 2032-BNS conversion (DD n.94/2022)	3.4	2.7	1.00	10	10
b. Nonmarketable bonds	**39.3**	**22.4**			
Perpetual Bond - CRSM	28.7	13.9	1.75	//	//
Perpetual Bond - CBSM[3]	1.2	0.0	0.10	//	//
Bonds former BNS	9.4	8.5			
BNS bond 2024	3.5	3.3	0.25	5	2
BNS bond 2026	5.9	5.2	0.35	7	4

[1] Present value calculated as the present value of new claims divided by the par value of old claims. The discount factor was 3.5 percent (based on the yield of 30 year government Italian bond).
[2] Maximum 4.5 percent.
[3] Accounted in present value in the stock of debt as it does not amortize and interest payments is almost zero. Nominal value of the bond is 19 millions.
Source: IMF staff estimates based on Sammarinese authorities.

15. **Banks' capitalization and profitability improved in 2021, but significant challenges remain.** For the first time in 12 years, profits of the banking system were positive, albeit still very low

by international standards, and losses again accrued in the first quarter of 2022. The expiration of a covid-related moratoria did not bring a significant increase in NPLs, which remain exceptionally high (around 60 percent of loans). In 2022, cost cuts stalled, and pressure emerged from the trading activity in a context of falling bond values. Such losses are only partially reflected as banks were allowed to transfer part of the trading book portfolio into investment portfolio retroactively to January 2022. After years of stability, a new challenge emerged in the nonbank sector as *Compagnia Sammarinese di Assicurazioni*, the smaller of the two insurance companies in San Marino, was put under extraordinary administration and its payments suspended. Finally, it was taken over by the remaining insurance company at no fiscal cost. The insurance sector is moderately sized (5.7 percent of financial system assets, or 18 percent of GDP).

16. **Deposits continue to grow, while domestic credit has yet to recover.** Amid higher capitalization, profitability and liquidity, confidence in the banks remains solid, with deposits reverting a long-term declining trend with a 4 percent year-on-year growth until March (deposits in foreign banks have, however, grown even more). In contrast, credit growth continued to be subdued as banks strive to increase capitalization ratios and increased demand for credit is met by greater lending from foreign banks.

17. **The external position in 2021 was moderately weaker than suggested by fundamentals and desired policies.** Both current account (CA) and index real exchange (IREER) models suggest similar results (Annex III).

OUTLOOK AND RISKS

18. **In the context of real income erosion, tightening financial conditions and growing global uncertainty, activity is expected to soften this year**. The manufacturing sector is the most exposed to the energy crisis given the sensitivity to high energy prices and the expected deceleration of the Italian and EU economies in the second half of this year. Domestic consumption will suffer further as the decline in real incomes deepen and uncertainty grows while tourism remains resilient. The current account will deteriorate as manufacturing exports weaken. Higher global interest rates (San Marino is a net creditor) can somewhat mitigate the current account deterioration but result in capital outflows and, as a consequence, lower international reserves.

Key Macroeconomic Indicators

	2022A4					2021A4				
	2021	2022	2023	2024	2025	2021	2022	2023	2024	2025
					Percent					
Real GDP growth	8.3	3.5	0.2	1.0	1.3	5.5	3.8	1.5	1.3	1.3
Inflation - avg	2.1	6.9	4.5	1.5	1.7	1.6	1.3	1.2	1.3	1.3
Nominal GDP growth	9.2	7.2	2.4	2.7	3.1	7.1	5.3	2.7	2.6	2.7
					Percent of GDP					
Current account balance	4.5	1.3	0.7	0.9	1.0	1.3	1.3	1.1	1.3	0.9
Primary balance net of bank support	-2.3	-1.2	-0.7	0.2	0.5	-2.6	0.3	0.9	0.8	0.7
of which transfers to AASS	...	-0.5	0.0	0.0	0.0	...	...	...	...	...
Public debt	86.3	83.7	94.6	84.5	84.1	94.3	91.7	90.6	89.6	89.0

Source: Sammarinese authorities, and IMF staff estimates.

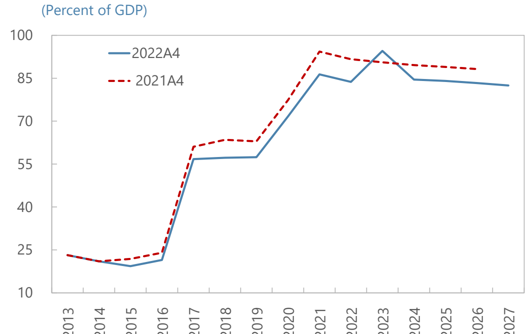
19. Inflation is expected to peak in late 2022 and decline next year. Inflation, at 6.9 percent in 2022, is projected to be below regional peers, amid subdued wage pressures and comparatively lower energy price increases. In 2023, lower commodity prices are expected to ease inflationary pressures (especially towards the second half of the year) and wages are expected to show lower increases (Box 2). However, electricity prices will increase significantly in January, around 50 percent.

20. In the absence of a fiscal adjustment, the fiscal position remains vulnerable. The primary balance net of bank support is projected to improve only marginally in 2023 with weaker economic activity having a negative impact on revenues. Thus, the improvement will be largely due to a cautious indexation of public wages and pensions below the increase in the GDP deflator and in line with private sector wage agreements (0.4 percent of GDP savings) and the lack of one-off expenses. With full pass-through of energy prices to consumers, no energy subsidies are projected next year. Pension reform, expected to be approved this year, will reduce social security deficits, and delay the potential need for higher transfers from the central government over the next decade.

21. As interest rates and energy prices become persistently higher, the banking system enters a stage of new challenges. Higher energy prices will likely result in higher NPLs. Furthermore, higher interest rates will result in some losses on fixed income portfolio (five times higher than banks' capital), adding further to the capitalization needs of banks once recognized. On the other hand, higher market rates are consistent with higher net interest margins, increasing structural profitability going forward.

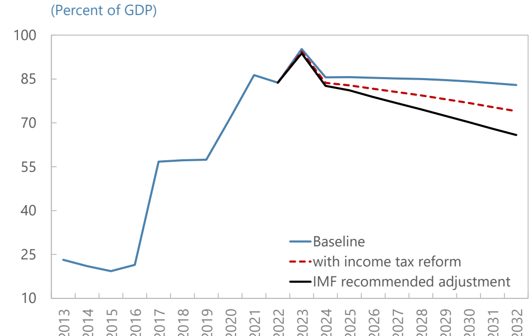
22. Public debt is projected to remain around current levels until 2024 and then start a declining trend not robust to most shocks and subject to very high financing needs that year. Debt over the medium-term will be marginally lower than projected last year (5 percentage points by 2026)—reaching around 83 percent of GDP in 2027 (annex IV). Over the medium-term and in the absence of a fiscal adjustment, the central government deficit will remain high. Pension reform, once approved, will prevent the expected rapid erosion in pension funds' assets and overall public sector liquidity over the medium-term. As an early issuance of the new Eurobond is likely, debt-to-GDP will temporarily spike in 2023 to subsequently decline when the Eurobond is repaid in 2024.

San Marino Public Debt
(Percent of GDP)



Sources: IMF staff estimates.

San Marino Public Debt Scenarios
(Percent of GDP)



Sources: IMF staff estimates.

23. Risks are unusually elevated as further disruptions to energy supply could weaken economic conditions significantly. Further disruptions in gas provision to Europe cannot be dismissed. In such a scenario, Italy is expected to resort to alternative sources of supply but short-term logistic constraints will likely require rationing. In an extreme case of a full shutoff, it is estimated that 15 percent of demand would have to be curtailed with losses to Italy's GDP estimated to range from 2–5 percent of GDP. This would result in an impact on San Marino of 1.5-4 percent of GDP driven largely by the heavy reliance of growth on manufacturing. However, Sammarinese manufacturing lacks the most affected energy-intensive industries such as cement, steel, or fertilizers. In this scenario the fiscal position would deteriorate beyond a cyclical revenue fall and financial stability could be at risk given remaining vulnerabilities.

24. Another key risk continues to be the rollover of the Eurobond that matures in early 2024 for about 20 percent of GDP. While markets have remained stable for San Marino, refinancing such magnitude can be challenging for a country with limited market presence, delays in fiscal reforms and deteriorated external conditions. Rollover risks would be exacerbated if global inflation remains high and triggers further tightening of global financial conditions.

25. The authorities highlighted the strong economic activity and stressed that a decisive reform agenda is needed to counter the deteriorating external environment. They anticipate higher inflation for longer and welcome the prudent collective wage agreement reached earlier this year that will help preserve employment and competitiveness. They see a strong reform agenda over the next few months as key to address heightened uncertainty and downside risks.

POLICY DISCUSSIONS: STRENGTHEN THE FRAMEWORK TO COPE WITH SHOCKS

A. Response to High Energy Prices and the Climate Challenge

26. San Marino has responded to high energy prices by allowing price signals to guide demand, while minimizing the disruptive economic impact and supporting vulnerable groups. Overall, the authorities have let the price signal mechanism work, preserved structural profitability in energy activities at AASS while providing—at a limited fiscal cost—an element of smoothing to households and firms that helped them adapt to the new price environment. They limited the increase in import prices this year:

- ***For electricity*** through a one-year future market contract and only partially passing-through new import prices to consumers by reducing previous large margins at AASS.

- ***For gas***, through a new long-term fixed price gas contract (signed at late-February at one-fourth of July's spot price) while isolating consumers from volatile and unprecedently high spot prices

pre-contract by maintaining old tariffs and incurring temporary losses in AASS. Subsequently, tariffs have been adjusted above cost-recovery given new import prices.

27. **With advantageous gas and electricity import prices this year and next, the authorities are rightly adjusting tariffs to ensure cost recovery**. This has allowed them to avoid public subsidies and let the price signal mechanism work, while maintaining tariffs significantly below regional peers. Beyond 2023, tariffs would need to gradually adjust to their new long-term equilibrium while targeted and temporary support should be provided to vulnerable groups. After years of very stable tariffs, plans to index tariffs to wholesale prices should be carefully considered to avoid excess transfer of risks and volatility to consumers.

28. **Given the large impact of potential gas supply disruptions, the authorities are developing a comprehensive emergency plan and enhancing coordination with Italy.** It should also incorporate a strategy for rationing energy that could include an auction mechanism to ensure gas demand reductions happen where it is less costly. Securing adequate levels of gas storage, if feasible and even at a high cost, should also be considered in the current environment.

29. **High energy prices and energy insecurity provide an incentive to accelerate the energy transition that will also need to ensure energy affordability and security.** San Marino is developing an ambitious plan to increase renewable capacity, although land constraints are an obstacle. Further progress on energy efficiency could be enhanced through taxation, below Italy.

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

30. **Increasing global interest rates, elevated public debt, and the large Eurobond rollover in 2024, call for an ambitious path for fiscal policy.** Therefore, fiscal policy should support a faster decline in debt more robust to shocks, a permanently higher level of government liquidity, and stabilize pension fund reserves. This will be key to ensure stability, preserve confidence and reduce the risk associated with the rollover of the Eurobond. Ideally, fiscal adjustment should be frontloaded enough to reassure markets that the fiscal path is credible. Thus, San Marino should target a primary balance (net of bank support) for the central government of around 2.5 percent of GDP within three years. Accounting for current revenue and expenditure plans, further consolidation efforts are about 2 percent of GDP. This should be complemented by pension reform to stabilize the pension system's deficit (net of government transfers) at 2.5 percent of GDP over the medium-term (see Article IV 2021). The current pension

Measures That Could Help to Achieve the Recommended Primary Balance
(Percent of GDP)

Tax increases	**2.2**
Reducing income tax rebates	1
VAT	0.6
Expanding excises	0.1
Wealth tax	0.5
Spending cut	**1**
Reduction in transfers to other government units	1
Total yield	**3.2**

Source: IMF staff estimates.

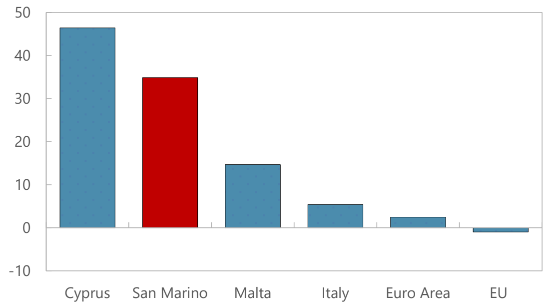
Medium-Term Fiscal Indicators and Recommended Targets
(Percent of GDP)

	Baseline			Proposed adjustment scenario		Fiscal consolidation needed 2/	
	2022	2025	2027	2025	2027	2025	2027
CG: Primary Balance net of bank support	**-1.2**	**0.5**	**0.8**	**2.5**	**2.5**	**2.0**	**1.7**
CG: Primary Balance net of transfer to the Pension Fund [a]	1.3	3.0	3.2	5.0	5.0	2.0	1.8
Pension Fund Balance net of government transfers [b]	-4.1	-2.8	-3.1	-2.5	-2.5	0.4	0.6
Consolidated Primary Balance 1/	**-2.8**	**0.1**	**0.1**	**2.5**	**2.5**	**2.4**	**2.4**

1/ Consolidated primary balance of the central government and the Pension Funds ([a]+[b])
2/ Difference between the proposed adjustment scenario minus baseline

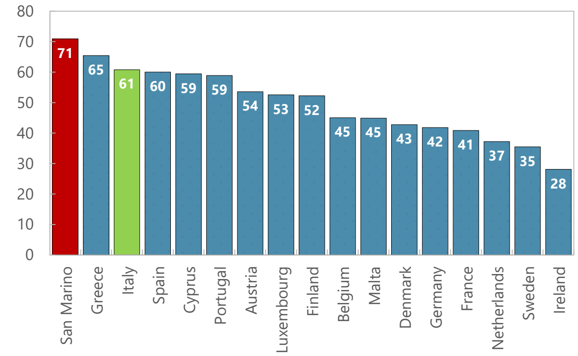
reform reduces deficits broadly in line with past recommendations but only over the next 7 years making further reform at that time necessary.

Public-Private Wage Gap[1]
(Percent of private wages)



1/ 2021 for San Marino, and 2018 for the Cyprus, Malta, Italy, EA and EU.
Sources: Country authorities; Eurostat; and IMF staff estimates.

Average Pension, 2019
(In percent of average wage)



Sources: IMF staff estimates.

31. To achieve a credible fiscal consolidation the authorities should:

- **Mobilize revenue by improving the efficiency of the income tax and introducing a VAT.** The planned income tax amendments would broaden the base by reducing tax allowances and incentives for businesses. However, there is more room for simplifying the tax system increasing its efficiency. The introduction of a VAT remains the key priority given its revenue and efficiency potential. In addition, as the price of fuel declines, the authorities should consider expanding the use of excise duty to generate revenue and address environmental externalities.

Box 3. Income Tax Amendments

- Reduction in the standard deduction (€2,800 to €1,400 per taxpayer).
- Reduction in expense deductions paid with the San Marino Card (SMaC) for high income taxpayers.
- Harmonizing standard deductions of pensioners and workers.
- Increasing the minimum value of investments for deductions and reducing the amounts deductible.
- Scaling down the carry-forward of losses from 80 to 70 percent.

- **Improve the efficiency of public spending.** Enforcement of spending reviews across all public sector units as well as improved accounting, reporting, and transparency are needed to enhance control of public finances in the context of a comprehensive public financial management reform. Finally, better targeting of social programs through the adoption of income and wealth indicators could yield further savings without worsening social outcomes.

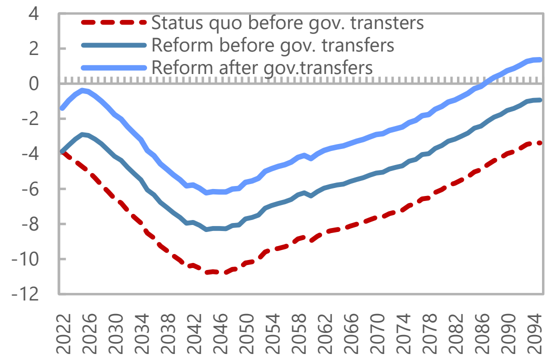
- **Implement pension reform** (Box 4). This is a priority given increasing deficits of the Social Security over the medium-term. The pension system is not sustainable due to aging population,

generous benefits, and low penalties for early retirement.[4] The reform under parliamentary discussion aims to increase the effective retirement age, increase contribution rates significantly, and increase the link between benefits and contributions. However, low penalties for early retirement remain an issue.

Box 4. Key Elements of the Pension Reform Under Parliamentary Discussion

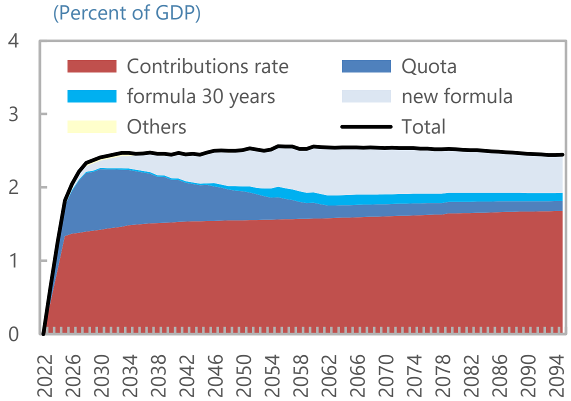
- An increase in quota (the sum of age plus years of contribution) from 100 to 103.
- A gradual increase of 3 percentage points on employees' contribution rate for pillar one[1]
- Pension based on 30 years of work-career instead of the last 20 years.
- Amendments to the benefits calculation to be better aligned with contributions.
- An increase in solidarity contributions.
- Greater flexibility to work part-time after retirement.

Pension Balance
(Percent of GDP)



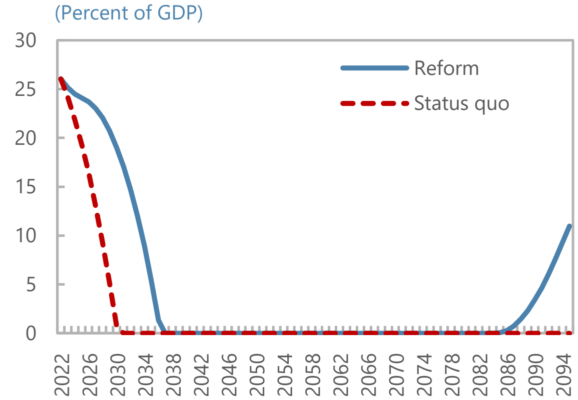
Sources: Sammarinese authorties, and IMF staff estimates.

Savings from the Pension Reform
(Percent of GDP)



Sources: Sammarinese authorties, and IMF staff estimates.

Pension Fund Assets
(Percent of GDP)



Sources: Sammarinese authorties, and IMF staff estimates.

[1] Currently employees pay 16.1 percent and employers pay 5.4 percent contributions.

32. Building a medium-term perspective to fiscal policy will strengthen the fiscal framework and increase stability and predictability. This would include a credible and comprehensive medium-term fiscal consolidation plan, key to ensure sustainability and reflect plans to change taxes and improve the efficiency of government expenditure.

33. Maintaining high government liquidity is critical to reduce rollover risks and support financial stability. The authorities should maintain deposits of at least 2 months of spending (about 4 percent of GDP) on average to ensure that the government can respond to shocks. Furthermore,

[4] IMF Country Report No. 19/85.

increasing the level of government liquidity ahead of the Eurobond rollover in 2024 should be considered as it will allow to reduce the demand for international funding in case of the materialization of adverse scenarios.

34. Large gross financing needs associated with the rollover of the Eurobond emphasize the need to institutionalize public debt management. The strengthening of the debt office is a step forward that needs to be followed by the development of a debt management strategy. The objective of such a strategy should be to minimize rollover risks while simultaneously minimizing financial costs. The strategy should balance international and domestic market issuances that will help develop the domestic bond market. To deepen the domestic bond market, it is important to provide more predictability and transparency on issuances and consolidating government bond issuance on a few maturities (at most three). In addition, publishing a medium-term debt strategy document and an annual debt report will add predictability.

35. The authorities agree on the urgency to accelerate fiscal reforms to ensure debt sustainability and financial stability. They highlight that the pension reform will be implemented next year preserving the system financial soundness for the next decade. While the reform eliminates the increasing deficits over the medium-term, the authorities agree that further parametric adjustments will likely be needed in ten years. They are planning to send the income tax reform to parliament in early 2023 with the goal to simplify the system and reduce allowances. The authorities continue working to improve public financial management and improve spending efficiency including through the ongoing public sector reform. They agree that there is a need to build a medium-term fiscal strategy including through more predictable debt management. Regarding the rollover of the Eurobond, the authorities plan to take an opportunistic approach and be ready to take advantage of favorable market conditions as soon as early next year.

C. Reforms to Strengthen the Banking System

36. An ambitious strategy to reduce NPLs, including an Asset Management Company (AMC) and the introduction of calendar provisioning should not be delayed further. The AMC's key objective is to purchase exceptionally high nonperforming loans (NPLs) from banks[5]. Calendar provisioning will involve automatic gradual provisioning increases for NPLs and is expected to be introduced in June 2023. The governance and incentive schemes of the AMC remain key. A new decree has established rules governing the servicer IGRC[6] and three reputable international firms have been shortlisted as arrangers. A new draft regulation on the supervisory treatment of AMC bonds establishes zero risk weight for senior guaranteed bonds but a three times larger risk weight factor for junior bonds than existing NPLs, becoming progressively higher over time.

37. A faster pace of strengthening private banks' capitalization is warranted. Capitalization in private banks remains mixed. With the majority of private banks featuring low and fragile

[5] IMF Country Report No. 21/249.

[6] Istituto per la gestione e il recupero dei crediti.

profitability, banks need to resort to more aggressive injections of fresh capital as the key tool to address gaps. Deficiencies in capital strengthening plans or further delays in their implementation should be met with strengthened use of supervisory corrective measures.

38. **The transfer price of NPLs and the prudential treatment of AMC bonds remain crucial to avoid artificial increases of banks' capital.** NPLs should be transferred at real value as determined by an internationally recognized appraiser. If transferred at book value, as per the current legislation, and depending on the share of NPLs that are exchanged for senior bonds (determined by the market), the current supervisory guidelines could allow the transfer of NPLs to result in a reduction of banks' risk-weighted assets and artificially higher capital ratios. Staff believes the proposed prudential treatment should be complemented with a lower bound of provisioning to eliminate this possibility and ensure the offloading of NPLs results in further reductions to banks' capitalization. However, to incentivize banks, those banks that delay NPL transfers should be subject to higher capital requirements and significantly more aggressive calendar provisioning. In this connection, the expected delay in implementing calendar provisioning should be avoided. Improving the insolvency regime to complement reforms implemented last year remains a priority.

39. **In order to boost the quality of CRSM's capital, the perpetual bond should be gradually converted into tradable bonds**. The recapitalization through a perpetual bond was an important first step but the bond is illiquid. A strong capital position will require a gradual transformation into a marketable, liquid, domestic debt instrument consistent with a broader public sector debt management strategy. Notwithstanding recent progress, to achieve healthy profitability, significant measures are still required (including further improving underwriting standards and rationalization of the branch network and personnel costs) and potential dividends should be used for further recapitalization of the bank.

40. **The CBSM's lender of last resort (LOLR) capability should be further protected.** The recent reduction in reserves was expected given higher interest rates in Europe, but further reductions should be avoided so that the LOLR capacity of the CBSM remains sufficient in a euroized economy. Reserve requirements should be increased to lock in a higher level of deposits, and there is room for government deposits to be increased further. In this connection, new sources of risks associated with energy developments reinforce the need for buffers. In addition, the recent rules that allow diversification of pension fund assets abroad can cause a potential outflow that would reduce further the liquidity of the overall system. Thus, this flexibility should be applied gradually at predetermined dates, backloading the liberalization after the Eurobond rollover.

41. **Losses on bond holdings should be fully disclosed to ensure transparency.** With higher interest rates becoming part of the landscape for some time to come, the measure to transfer financial instruments to banks investment portfolios is not justified and should be avoided. It creates uncertainty about the losses incurred by banks, and their current degree of undercapitalization.

42. **San Marino should continue to make progress in strengthening implementation of the AML/CFT framework.** The 2021 AML/CFT assessment report by MONEYVAL indicated satisfying levels of effectiveness in many areas and identified remaining challenges, which need to be

addressed. In line with the report, FIA's resources should be increased to enhance supervision of (and thus compliance by) the financial and DNFBP sector, including for sanctions compliance (also in relation to the war in Ukraine). The authorities are also in the process of transposing the EU AML directive into the domestic legal framework to improve technical compliance.

43. The authorities agreed that to continue strengthening banks, further efforts to increase banks profitability and capitalization are needed, together with NPL reduction. They also agreed that CBSM liquidity is a key priority to perform the LOLR role. They expressed that banks' transfers of securities to investment portfolio will be clearly presented in their reports to ensure full transparency. They emphasized that the process to securitize NPLs together with the implementation of capital provisioning in line with the European framework, will allow a rapid reduction of NPLs in the banking system.

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

44. Structural reforms remain critical to increase potential growth:

- **Labor Market Reform** (Annex V). A labor reform under discussion would, among other things, facilitate reskilling and reintegration of long term unemployed, provide loans to facilitate higher education, and support female employment. At the same time, facilitating the hiring of cross border workers would help meet the demand for more workers in a tight labor market.

- **Economic integration.** The authorities are stepping up efforts to complete the EU association agreement technical work by end-2023. The agreement is a priority as it will support domestic reforms and unlock growth by fostering financial, trade, and labor integration.

45. The authorities emphasize that the labor market reform will enhance labor market flexibility, needed in a small open economy, and support competitiveness. The reform, under parliamentary discussion, is expected to be approved this year. The authorities are optimistic that the new momentum behind the EU association agreement will result in a final agreement next year.

46. The authorities have timely published the data on their National Data Summary Page, following the IMF's Enhanced General Data Dissemination System (e-GDDS). The data provision remains broadly adequate for surveillance, though its frequency and quality need to continue improving. To support statistical development, it will be key to develop a statistics law.

STAFF APPRAISAL

47. 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.

48. 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.

49. 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.

50. 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.

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

52. 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.

53. 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.

54. 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.

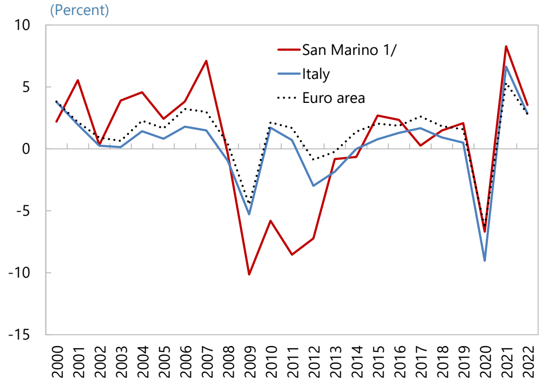
55. Reforms that preserve and support macroeconomic stability should be complemented with structural reforms needed to boost long-term growth. Progress towards the EU association agreement and the labor market reform are welcome but should be completed and implemented. In particular, labor market reform 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.

56. It is recommended that the next Article IV consultation takes place on the standard 12-month cycle.

Figure 1. San Marino: Macroeconomic Developments

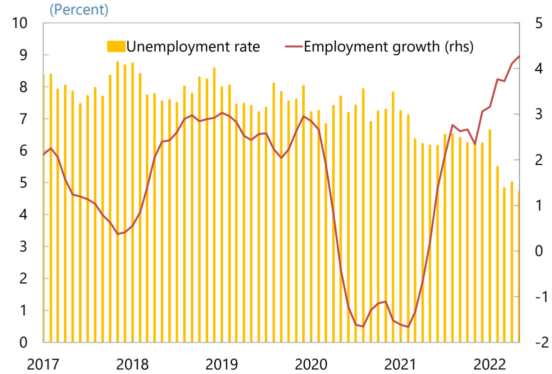
Real GDP is estimated to have rebounded in 2021…

Real GDP Growth
(Percent)



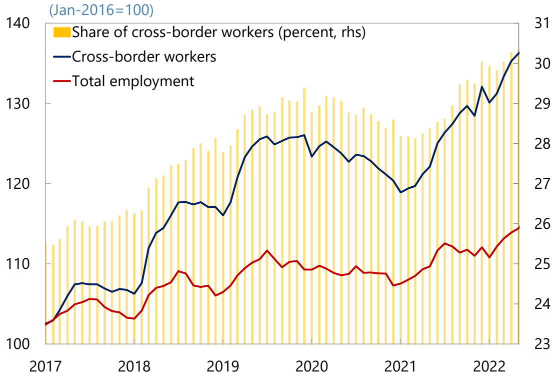
…with robust growth in employment and low unemployment rate.

Unemployment Rate and Employment Growth
(Percent)



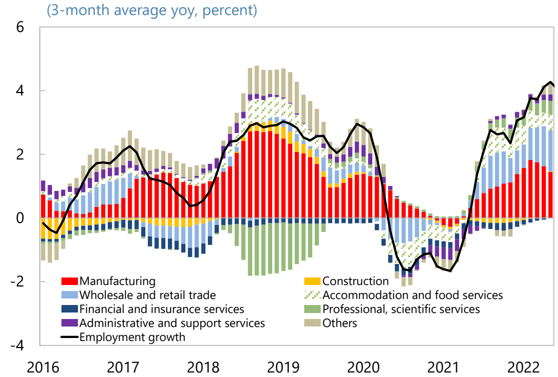
Hiring of cross-border workers continued increasing….

Employment and Cross Border Workers
(Jan-2016=100)



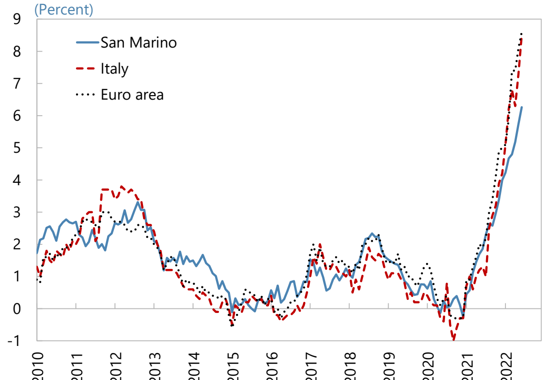
…and employment in the tourism related sectors gained momentum.

Sectoral Contributions to Employment Growth
(3-month average yoy, percent)



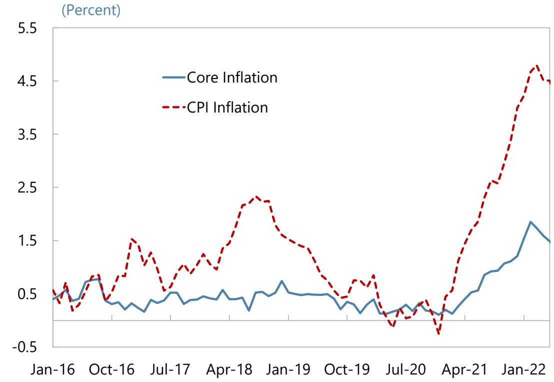
Overall inflation has picked up recently…

CPI Inflation
(Percent)



…as did core inflation, though it remains at moderate levels.

San Marino: CPI and Core Inflation
(Percent)

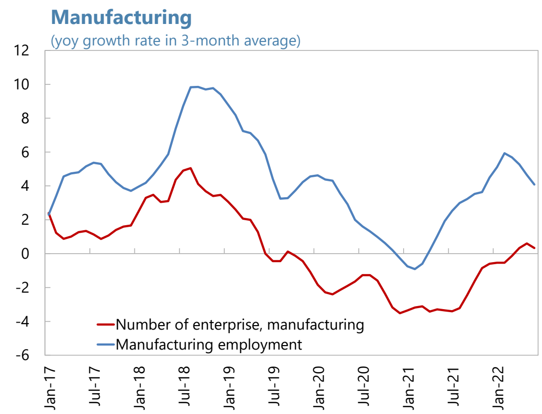


1/ Projections for 2021 and 2022.

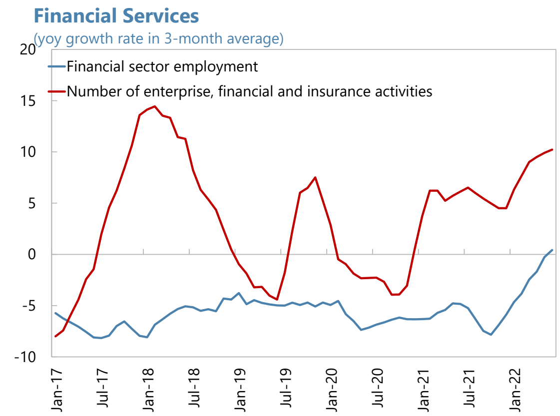
Sources: World Economic Outlook, Sammarinese authorities, and IMF staff.

Figure 2. San Marino: High Frequency Indicators

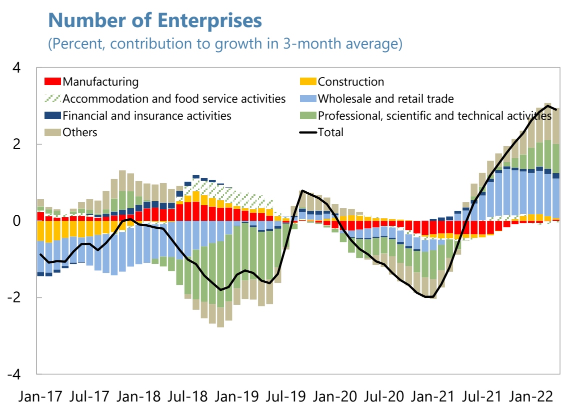
Manufacturing activity has remained strong….



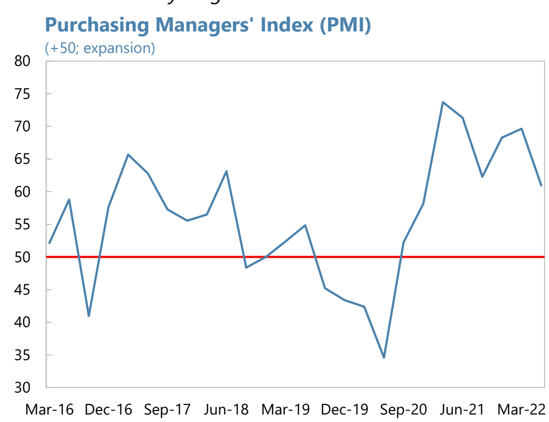
…while financial services start growing.



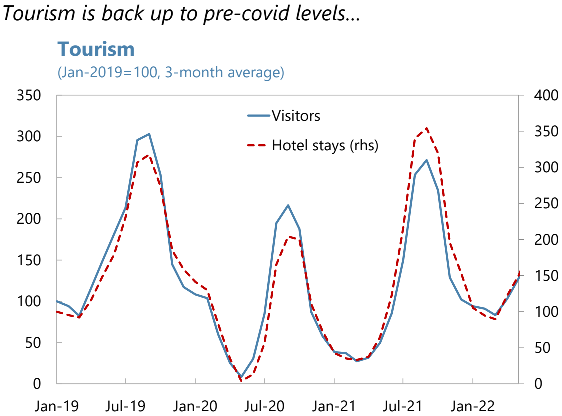
The number of active enterprises is gaining momentum…



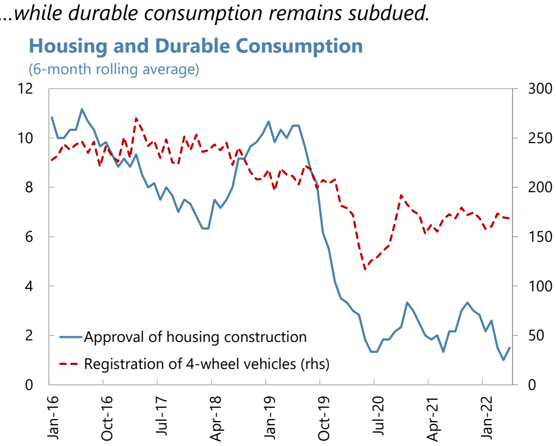
…while the PMI stays high.



Tourism is back up to pre-covid levels…

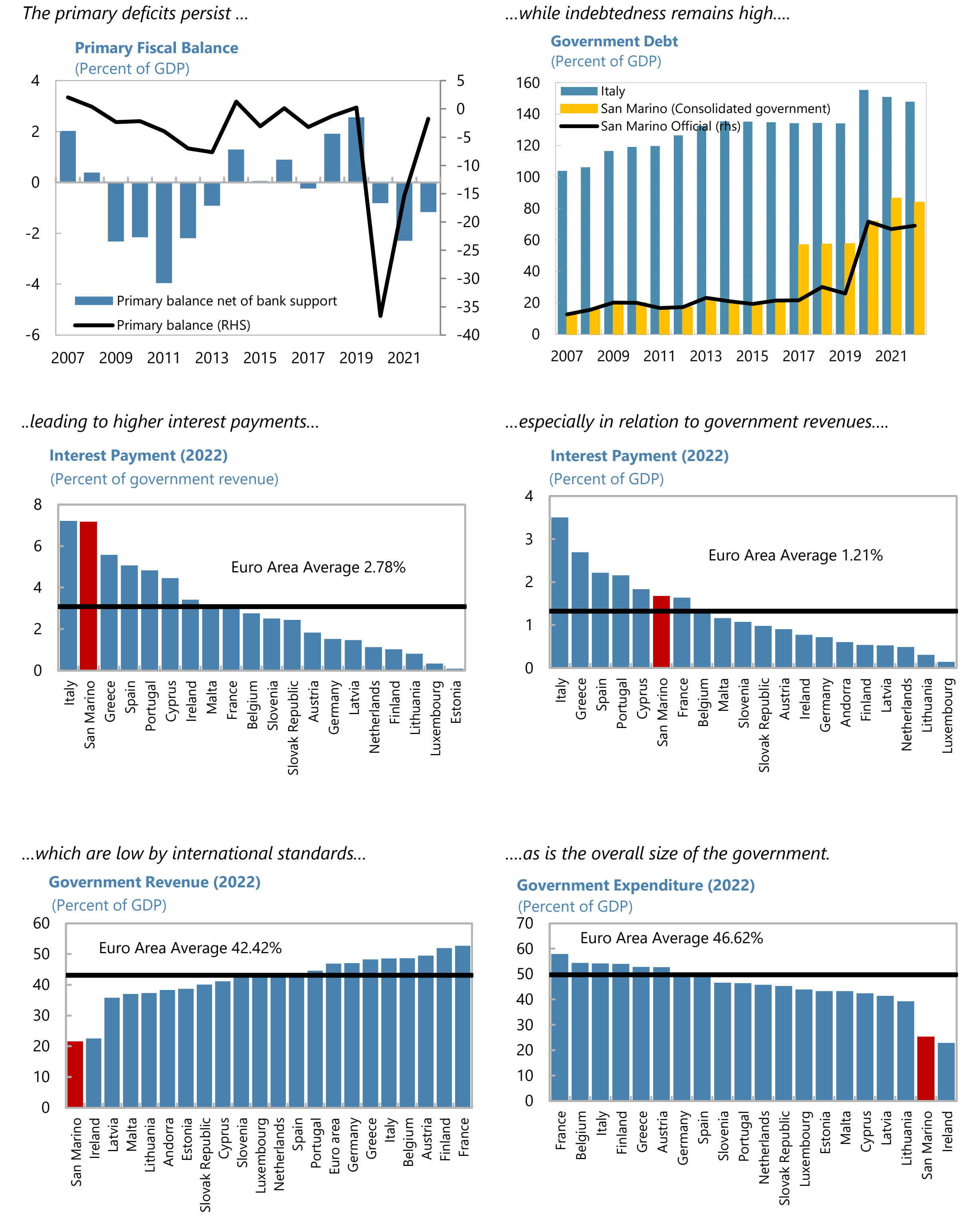


…while durable consumption remains subdued.



Sources: Sammarinese authorities and IMF staff.

Figure 3. San Marino: Fiscal Developments

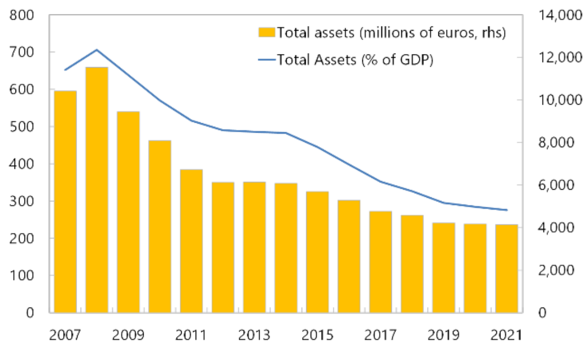


Sources: Sammarinese authorities, World Economic Outlook.

Figure 4. San Marino: Monetary and Banking Developments

Banking system assets have stabilized......

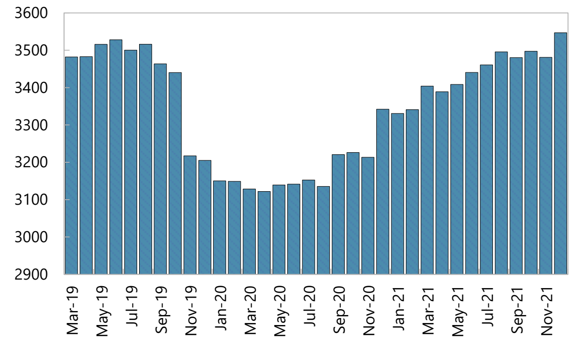
Banking System Assets



...with deposits recovering since the Eurobond issuance improved system liquidity

Customer Deposits 1/

(Millions of euros)

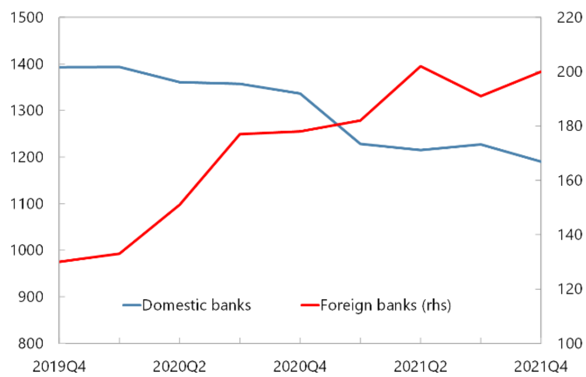


1/ Includes demand deposits, term deposits, and certificates of deposit.

Banks credit remains subdued despite strong growth...

Bank Credit to Sammarinese Firms

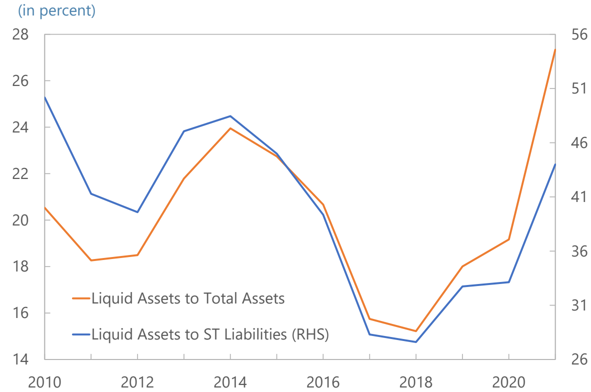
(Billions of euros)



...with liquidity recovering.

Banking Sector Liquidity

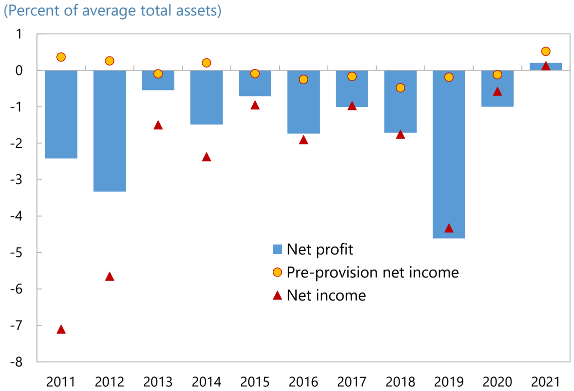
(in percent)



Profitability has returned...

Banking Sector's Profitability

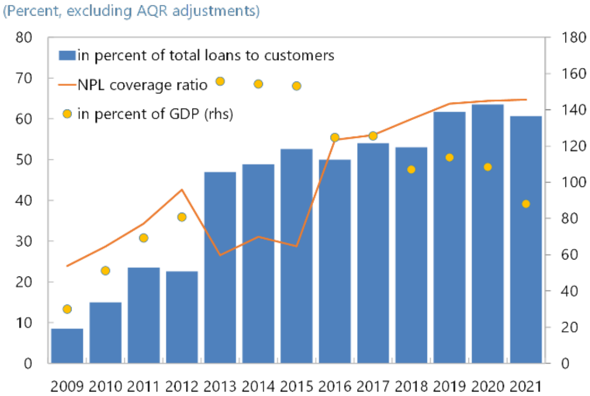
(Percent of average total assets)



...but NPLs remain extraordinarily high.

Banking Sector's Non-Performing Loans

(Percent, excluding AQR adjustments)



Sources: Sammarinese authorities and IMF staff.

Table 1. San Marino: Selected Economic and Social Indicators, 2019–27

GDP per capita (2020): 45,641 U.S. dollars — Life expectancy at birth (2018): 86.6 years

Population (2020): 33,574 persons — Literacy, adult (2015): 96 percent

			Est.	Projection					
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Activity and Prices									
Real GDP (percent change)	2.1	-6.7	8.3	3.5	0.2	1.0	1.3	1.3	1.3
Domestic demand	6.2	-10.4	6.2	1.8	1.2	1.3	1.1	1.1	1.1
Final consumption	1.4	-2.3	3.2	1.3	1.0	1.0	1.0	1.0	1.0
Fixed investment	17.8	-25.2	7.2	4.0	3.5	3.5	3.0	3.0	3.0
Net exports	-2.6	1.5	3.6	2.2	-0.7	0.1	0.5	0.5	0.5
Exports	0.6	-7.3	14.5	6.8	1.8	1.7	1.8	1.7	1.8
Imports	2.4	-9.4	14.5	6.5	2.5	2.0	1.7	1.8	1.7
Contribution to GDP	2.1	-6.7	8.3	3.5	0.2	1.0	1.3	1.3	1.3
Domestic demand	4.5	-7.3	3.2	1.4	1.2	1.2	1.1	1.1	1.1
Final consumption	0.8	-1.3	1.8	0.7	0.5	0.5	0.5	0.5	0.5
Fixed investment	3.7	-6.0	1.4	0.8	0.7	0.7	0.6	0.6	0.6
Inventories	0.2	-0.9	1.5	-0.1	-0.3	-0.2	-0.3	-0.3	-0.3
Net exports	-2.6	1.5	3.6	2.2	-0.7	0.1	0.5	0.5	0.5
Employment (percent change)	2.6	-0.5	1.4	1.5	0.8	0.6	0.7	0.7	0.3
Unemployment rate (average; percent)	7.7	7.3	5.8	5.4	5.0	5.1	5.1	5.1	5.1
Inflation rate (average; percent)	1.0	0.2	2.1	6.9	4.5	1.5	1.7	1.9	1.8
Nominal GDP (millions of euros)	1,444	1,352	1,477	1,583	1,621	1,665	1,716	1,771	1,827
Public Finances (percent of GDP) 1/									
Revenues	22.3	21.6	21.9	21.5	20.8	20.9	21.0	21.0	21.0
Expenditure	22.4	59.2	39.4	24.8	24.0	24.5	23.9	23.7	23.6
Overall balance	-0.1	-37.6	-17.4	-3.3	-3.2	-3.5	-3.0	-2.8	-2.6
Primary balance net of bank support	2.6	-0.8	-2.3	-1.2	-0.7	0.2	0.5	0.7	0.8
Government debt (official) 2/	25.9	71.6	66.9	69.0	80.2	70.6	70.5	70.2	69.7
Public debt 2/ 3/	57.4	71.6	86.3	83.7	94.6	84.5	84.1	83.3	82.5
Money and Credit									
Deposits (percent change)	-11.9	3.1	3.2	...	...	...	...	...	...
Private sector credit (percent change)	1.0	-4.1	-10.8	...	...	...	...	...	...
Net foreign assets (percent of GDP)	123.5	130.7	145.8	...	...	...	...	...	...
Commercial banks	96.1	94.4	92.8	...	...	...	...	...	...
Central bank	27.4	36.3	53.0	...	...	...	...	...	...
External Accounts (percent of GDP)									
Current Account	2.0	2.8	4.5	1.3	0.7	0.9	1.0	1.1	1.1
Exports	159.5	157.9	178.1	183.1	181.6	181.0	180.8	180.4	180.2
Imports	148.2	144.5	162.5	172.1	172.0	171.6	171.1	170.9	170.7
Gross international reserves (millions of euros)	410.6	636.8	844.1	652.1	632.1	622.1	622.1	622.1	622.1

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

1/ For the central government.

2/ Debt statistics have been corrected for 2014-21.

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

Table 2a. San Marino: Statement of Operations for Budgetary Central Government, 2019–27

(Millions of euros)

			Est.	Proj.					
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenue	322.5	291.9	324.3	340.6	336.8	348.7	359.9	371.7	383.9
Taxes	232.8	195.8	251.2	272.6	265.1	272.9	281.8	291.1	300.8
Income Taxes	131.8	119.4	141.8	149.3	139.9	143.7	148.1	152.8	157.7
Non-income taxes	100.9	76.4	109.4	123.2	125.1	129.3	133.7	138.3	143.1
Taxes on international trade and transactions	61.9	40.8	68.7	78.2	82.1	85.1	88.1	91.3	94.6
Other taxes	39.1	35.5	40.7	45.1	43.1	44.2	45.6	47.0	48.5
Non-tax revenue	89.8	96.2	73.1	68.0	71.7	75.8	78.1	80.6	83.2
Expenditure	324.1	800.3	581.8	392.3	388.9	407.4	410.8	420.4	431.8
Current Expenditure	304.0	795.9	580.2	379.2	387.9	406.3	409.6	419.1	430.4
Compensation of employees	91.5	85.6	90.4	92.1	94.9	97.7	99.2	99.9	100.8
Use of goods and services	23.2	21.3	23.6	26.2	33.8	27.5	28.3	29.2	30.1
Interest	5.0	12.9	29.9	23.7	25.6	47.3	44.0	45.3	47.0
Transfers	181.0	672.9	432.3	230.5	226.7	226.7	230.8	237.1	244.6
To other general government units	127.7	164.9	205.9	190.7	188.3	188.3	191.2	197.2	203.5
Bank Support	33.5	484.5	193.7	9.5	15.6	15.4	15.3	15.0	14.8
To other private sector entities	19.8	23.5	32.6	30.2	22.8	23.0	24.3	24.8	26.3
Other expenses (including subsidies)	3.3	3.2	3.9	6.7	6.9	7.1	7.3	7.5	7.8
Net acquisition of non-financial assets	20.1	4.4	1.7	13.1	1.0	1.1	1.2	1.3	1.5
Overall Balance	-1.6	-508.4	-257.6	-51.7	-52.1	-58.7	-50.9	-48.7	-47.9
Memorandum items									
Primary Balance	3.4	-495.5	-227.6	-28.0	-26.5	-11.4	-6.9	-3.4	-0.9
Primary Balance net of bank support	**36.9**	**-11.0**	**-33.9**	**-18.4**	**-11.0**	**4.0**	**8.4**	**11.6**	**14.0**
Primary Balance net of transfer to the Pension Fund [a]	42.1	-445.3	-172.7	21.3	29.2	45.5	50.8	54.8	58.1
Pension Fund Balance net of government transfers [b]	-49.4	-69.9	-69.1	-65.0	-55.5	-51.7	-48.9	-51.2	-56.5
Consolidated Primary Balance 1/	-7.3	-515.2	-241.8	-43.7	-26.3	-6.2	1.9	3.6	1.6
Consolidated Primary Balance net of Bank Support 2/	**36.9**	**-40.4**	**-57.8**	**-43.7**	**-26.3**	**-6.2**	**1.9**	**3.6**	**1.6**
Public debt (official) 3/	373.9	969.0	987.7	1,092.7	1,300.4	1,174.5	1,209.9	1,242.5	1,273.8
Public debt 3/ 4/	828.9	969.0	1,275.7	1,325.7	1,533.4	1,407.5	1,442.9	1,475.5	1,506.8
Nominal GDP	1,443.7	1,352.4	1,477.4	1,583.2	1,621.5	1,664.7	1,716.2	1,770.7	1,826.9

Sources: Sammarinese authorities; and IMF staff.

1/ Consolidated primary balance of the central government and the Pension Funds ([a]+[b]);

2/ Bank support from 2022 are transfers to the Pension Fund related to BCIS bailout.

3/ Debt statistics have been corrected backwards for 2014-21 by about 6 percent of GDP.

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

Table 2b. San Marino: Statement of Operations for Budgetary Central Government, 2019–27

(Percent of GDP)

			Est.	Proj.					
	2019	2020	2021	2022	2023	2024	2025	2026	2027
Revenue	22.3	21.6	21.9	21.5	20.8	20.9	21.0	21.0	21.0
Taxes	16.1	14.5	17.0	17.2	16.3	16.4	16.4	16.4	16.5
Income Taxes	9.1	8.8	9.6	9.4	8.6	8.6	8.6	8.6	8.6
Non-income taxes	7.0	5.6	7.4	7.8	7.7	7.8	7.8	7.8	7.8
Taxes on international trade and transactions	4.3	3.0	4.7	4.9	5.1	5.1	5.1	5.2	5.2
Other taxes	2.7	2.6	2.8	2.8	2.7	2.7	2.7	2.7	2.7
Non-tax revenue	6.2	7.1	4.9	4.3	4.4	4.6	4.6	4.6	4.6
Expenditure	22.4	59.2	39.4	24.8	24.0	24.5	23.9	23.7	23.6
Current Expenditure	21.1	58.8	39.3	24.0	23.9	24.4	23.9	23.7	23.6
Compensation of employees	6.3	6.3	6.1	5.8	5.8	5.9	5.8	5.6	5.5
Use of goods and services	1.6	1.6	1.6	1.7	2.1	1.7	1.7	1.7	1.7
Interest	0.3	1.0	2.0	1.5	1.6	2.8	2.6	2.6	2.6
Transfers	12.5	49.8	29.3	14.6	14.0	13.6	13.4	13.4	13.4
To other general government units	8.8	12.2	13.9	12.0	11.6	11.3	11.1	11.1	11.1
Bank Support	2.3	35.8	13.1	0.6	1.0	0.9	0.9	0.8	0.8
To other private sector entities	1.4	1.7	2.2	1.9	1.4	1.4	1.4	1.4	1.4
Other expenses (including subsidies)	0.2	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Net acquisition of non-financial assets	1.4	0.3	0.1	0.8	0.1	0.1	0.1	0.1	0.1
Overall Balance	-0.1	-37.6	-17.4	-3.3	-3.2	-3.5	-3.0	-2.8	-2.6
Memorandum items									
Primary Balance	0.2	-36.6	-15.4	-1.8	-1.6	-0.7	-0.4	-0.2	0.0
Primary Balance net of bank support	**2.6**	**-0.8**	**-2.3**	**-1.2**	**-0.7**	**0.2**	**0.5**	**0.7**	**0.8**
Primary Balance net of transfer to the Pension Fund [a]	2.9	-32.9	-11.7	1.3	1.8	2.7	3.0	3.1	3.2
Pension Fund Balance net of government transfers [b]	-3.4	-5.2	-4.7	-4.1	-3.4	-3.1	-2.8	-2.9	-3.1
Consolidated Primary Balance 1/	-0.5	-38.1	-16.4	-2.8	-1.6	-0.4	0.1	0.2	0.1
Consolidated Primary Balance net of Bank Support 2/	**2.6**	**-3.0**	**-3.9**	**-2.8**	**-1.6**	**-0.4**	**0.1**	**0.2**	**0.1**
Public debt (official)	25.9	71.6	66.9	69.0	80.2	70.6	70.5	70.2	69.7
Public debt 3/ 4/	57.4	71.6	86.3	83.7	94.6	84.5	84.1	83.3	82.5
Nominal GDP (in millions of euros)	1,444	1,352	1,477	1,583	1,621	1,665	1,716	1,771	1,827

Sources: Sammarinese authorities; and IMF staff.

1/ Consolidated primary balance of the central government and the Pension Funds ([a]+[b]);

2/ Bank support from 2022 are transfers to the Pension Fund related to BCIS bailout.

3/ Debt statistics have been corrected backwards for 2014-21 by about 6 percent of GDP.

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

Table 3. San Marino: Balance of Payments, 2019–27
(Percent of GDP, unless otherwise indicated)

	2019	2020	Est. 2021	Proj. 2022	2023	2024	2025	2026	2027
Current account balance	2.0	2.8	4.5	1.3	0.7	0.9	1.0	1.1	1.1
Balance of goods and services	11.3	13.4	15.7	11.0	9.6	9.4	9.7	9.5	9.5
Goods balance	9.8	12.0	12.2	9.0	8.4	8.6	8.9	9.0	9.2
Exports	115.2	115.6	134.0	138.9	138.0	137.6	137.5	137.3	137.1
Imports	105.4	103.6	121.7	129.9	129.6	129.1	128.5	128.2	128.0
Services balance	1.5	1.4	3.4	2.1	1.1	0.9	0.7	0.5	0.3
Exports	44.3	42.3	44.1	44.2	43.6	43.4	43.3	43.2	43.1
Imports	42.8	40.9	40.7	42.1	42.5	42.5	42.6	42.7	42.7
Income balance	-8.5	-9.7	-10.5	-8.9	-8.3	-7.9	-8.0	-7.9	-7.8
Credit	6.2	5.8	5.4	6.2	7.3	7.6	7.3	7.3	7.2
Debit	14.6	15.5	15.9	15.1	15.5	15.5	15.3	15.2	15.0
Secondary income balance	-0.8	-0.9	-0.7	-0.7	-0.6	-0.6	-0.6	-0.6	-0.6
Capital account balance	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account balance	5.9	9.2	8.2	1.6	0.9	1.1	1.3	1.3	1.3
Direct investments	0.0	0.0	0.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Portfolio investments	-11.6	1.5	-10.0	1.9	1.7	1.5	1.2	1.2	1.2
Other investments	6.2	-8.5	4.3	12.0	0.7	0.4	0.2	0.2	0.3
Change in reserve assets (increase = +)	11.3	16.1	13.8	-12.1	-1.2	-0.6	0.0	0.0	0.0
Net errors and omisions	-3.7	-6.2	-3.5	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items									
Nominal GDP (in millions of euros)	1,443.7	1,352.4	1,477.4	1,583.2	1,621.5	1,664.7	1,716.2	1,770.7	1,826.9
GIR (in millions of euros)	420.8	636.8	844.1	652.1	632.1	622.1	622.1	622.1	622.1
GIR in months of imports	2.4	3.9	4.2	2.9	2.7	2.6	2.5	2.5	2.4

Sources: San Marino Statistical Office and IMF staff.

Table 4. San Marino: Financial Soundness Indicators, 2016–22

	2016	2017	2018	2019	2020	2021	2022Q2
Capital adequacy ratios (percent) 1/							
Regulatory capital to risk-weighted assets	11.5	13.7	12.3	9.5	10.7	14.4	13.2
Capital to assets	6.2	6.5	6.2	4.2	4.0	5.1	5.0
Asset quality ratios (percent) 1/							
Nonperforming loans to total loans	47.1	51.6	50.7	58.9	61.1	59.0	56.3
Nonperforming loans net of provision to capital	361.8	250.5	260.6	362.0	340.3	212.3	198.0
NPL coverage ratio	26.1	56.0	58.2	63.6	64.4	65.0	67.0
Earning and profitability (percent) 1/							
Return on assets (ROA)	-3.4	-0.7	-1.3	-4.3	-0.4	0.3	0.0
Return on equity (ROE)	-44.8	-10.3	-17.2	-74.6	-7.7	3.8	-0.2
Interest margin to gross income	45.5	50.2	66.8	48.0	46.4	46.9	60.2
Non-interest expenses to gross income	105.3	108.4	141.2	137.7	98.7	68.9	79.1
Trading income to gross income	3.5	4.8	-23.1	3.8	-2.2	5.0	-14.4
Personnel expenses to non-interest expenditures	49.2	41.6	41.1	32.6	43.9	44.2	43.3
Liquidity (percent)							
Liquid assets to total assets	20.7	15.7	15.2	18.0	19.2	27.3	26.8
Liquid assets to short-term liabilities	39.3	28.3	27.6	32.7	33.1	44.0	44.6
Loans to deposits	153.8	141.4	125.6	124.1	108.4	71.3	68.2
Memo items							
Banking system assets (millions of euros)	5328.8	4795.3	4616.6	4213.1	4191.1	4143.7	4217.3
percent of GDP	401.7	354.4	329.4	291.8	309.9	280.5	266.4

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

1/ 2017-18 data do not reflect 2017 AQR results, while 2019 data reflect changes related to Banca CIS resolution.

Table 5. San Marino: Depository Corporations Survey, 2016–21[1]

(Millions of euros)

	2016	2017	2018	2019	2020	2021
Net foreign assets	**2,134.4**	**1,865.5**	**1,749.7**	**1,782.6**	**1,767.5**	**2,153.8**
Claims on nonresidents	3,052.7	2,609.9	2,391.1	2,343.1	2,306.2	2,629.5
Central Bank	401.2	274.6	270.5	395.2	490.6	783.2
Other Depository Corporations	2,651.5	2,335.3	2,120.6	1,947.9	1,815.5	1,846.3
Liabilities to Nonresidents	-918.3	-744.4	-641.4	-560.5	-538.6	-475.7
Central Bank	-0.1	-0.1	-0.2	-0.2	-0.2	-0.2
Other Depository Corporations	-918.2	-744.2	-641.2	-560.3	-538.4	-475.5
Net domestic assets	**1,294.1**	**1,054.6**	**1,072.5**	**1,020.0**	**1,035.9**	**631.6**
Net Claims on Central Government	-119.5	-295.0	-304.8	-197.3	137.9	1.0
Claims on State and Local Government	0.0	0.0	0.0	0.0	0.0	0.0
Claims on Public Nonfinancial Corporations	0.0	0.0	0.0	0.0	0.0	0.0
Claims on NBFIs	381.2	263.0	242.6	119.0	111.7	84.8
Claims on private sector	1,468.5	1,481.0	1,381.7	1,394.8	1,338.2	1,193.2
Corporates	914.2	925.9	859.5	870.6	838.0	709.8
Households	554.3	555.1	522.2	524.2	500.2	483.5
Capital and Reserves	470.3	414.8	387.9	289.9	332.1	333.5
Other items, net	-34.3	-20.3	-140.9	6.6	219.8	313.9
Broad Money	**3,069.7**	**2,667.9**	**2,624.4**	**2,523.4**	**2,617.0**	**2,738.7**
Currency in Circulation	0.0	0.0	0.0	0.0	0.0	0.0
Transferable Deposits	1,371.9	1,364.2	1,415.3	1,483.8	1,622.5	1,811.6
Other Deposits	1,697.8	1,303.7	1,209.2	1,039.7	994.5	927.1
Securities	0.0	0.0	0.0	0.0	0.0	0.0
Deposits excluded from Broad Money	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**	**0.7**
Securities and shares excluded from Broad Money	**358.1**	**245.4**	**189.8**	**273.3**	**185.8**	**46.1**
Loans	**0.0**	**6.2**	**7.3**	**5.3**	**0.0**	**0.0**
	(Percent)					
Growth rates	0.0	6.2	7.3	5.3	0.0	0.0
Net foreign assets	**-8.7**	**-12.6**	**-6.2**	**1.9**	**-0.8**	**21.9**
Net domestic assets	**5.7**	**-18.5**	**1.7**	**-4.9**	**1.6**	**-39.0**
Claims on private sector	-5.0	0.9	-6.7	1.0	-4.1	-10.8
Corporates	-3.3	1.3	-7.2	1.3	-3.8	-15.3
Households	-7.8	0.2	-5.9	0.4	-4.6	-3.4
Broad Money	**-3.8**	**-13.1**	**-1.6**	**-3.8**	**3.7**	**4.6**

Sources: International Financial Statistics and IMF Staff.

1/ Monetary statistics have been revised in September 2022.

Annex I. Risk Assessment Matrix[1]

Source of Risks	Impact if realized	Policy Response
High **Intensifying spillovers from Russia's war on Ukraine.** Further sanctions resulting from the war and related uncertainties exacerbate trade and financial disruptions and commodity price volatility, with Europe among the worst hit.	High Higher energy prices could increase losses in the state-owned energy company adding fiscal pressures. Alternatively, if high energy prices are passed through, they could erode households' income and businesses' viability.	• Prepare plans to ensure consumers tariffs reflect cost to ensure a rational use of energy. • Prepare temporary programs for low-income households. • Implement a temporary price stabilization mechanism.
Medium **De-anchoring of inflation expectations and stagflation.** Supply shocks to food and energy prices sharply increase headline inflation and pass through to core inflation, de-anchoring inflation expectations and triggering a wage-price spiral in tight labor markets. Central banks tighten monetary policy more than envisaged leading to weaker global demand, currency depreciations in EMDEs, and sovereign defaults. Together, this could lead to the onset of stagflation.	High As a sub-investment grade country with a large rollover need in 2024, San Marino is highly vulnerable to changes in sentiment in international markets. A spike in yields and risk premia could significantly increase the interest burden ahead, deteriorating the fiscal accounts, and making it difficult for San Marino to rollover the maturing Eurobond.	• Enhance credibility by accelerating structural, fiscal, and financial sector reforms to reduce vulnerabilities and strengthen fiscal sustainability. • Maintain high liquid buffers and explore alternative options to obtain external financing
High **Abrupt slowdown or recession linked to gas shutoff by Russia**. The fallout from the war in Ukraine is exacerbated by a gas shutoff by Russia, resulting in acute gas shortages and further supply disruptions, which triggers an EU recession.	Medium A recession on the Euro Area could reduce San Marino exports significantly and therefore impact vulnerable fiscal accounts. At the same time, such recessionary context could result in less aggressive interest rates hikes facilitating San Marino Eurobond rollover in 2024.	• Enhance credibility by accelerating structural, fiscal, and financial sector reforms to reduce vulnerabilities and strengthen fiscal sustainability • Provide limited and temporary support to mitigate the impact on vulnerable households and viable businesses.
High **Slow fiscal consolidation and delays in implementing fiscal reforms** due to lack of political capital and social consensus around these reforms	High The lack of clear fiscal consolidation path can challenge the Eurobond rollover in 2024. In the medium term, high level of public debt and a narrow tax base will increase vulnerabilities and limit the government's ability to respond to shocks. It will also crowd out productive spending, thus undermining growth.	• Advance fiscal reforms, develop debt management capacity, and establish a Treasury department. • Diversify financing options; and seek technical support as needed.
High **Slow banking system repair.** Limited progress in addressing further recapitalization needs and cleaning up bank balance sheets. Slow improvement of profitability because of wage rigidity and greater competition from Italian banks.	High Insufficient implementation of measures to restructure the banking sector will lead to a deterioration of confidence, financial outflows, liquidity pressures in the banking system, and retrenchment of credit with adverse growth implications.	• Extend central bank power and tools for tackling failing banks. • Apply bank resolution tools and liquidity safeguards on an "as needed" basis; and • Accelerate implementation of a financial sector strategy.

[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 is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities.

Annex II. Authorities' Response to Past IMF Recommendations

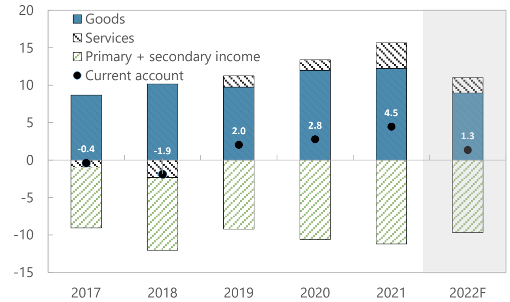
IMF Policy Advice from 2021 Consultation	Authorities' Action
Financial Sector Policy: • Increase reserve requirements • Time bound strategy for NPLs • Capital plans for banks • Continue improving banking system efficiency • Build risk-assessment capacity for CRSM • Strengthen supervision • Set AMC following best international practices	• Bank capitalization and profitability improved but significant challenges remain • Subdued credit growth • Delays in an ambitious strategy to reduce NPLs, including an Asset Management Company (AMC) and the introduction of calendar provisioning.
Fiscal Policy: • Fiscal adjustment over 3 years to 2.5% primary balance • Pension reform to ensure sustainability • Rollover short term debt • Build debt management capacity	• The government are amending the income tax law to reduce loopholes. • A pension reform draft has been prepared and being discussed by the authorities. • Short term debt was repaid. • The debt office has been strengthened with permanent staff and issued domestic bonds in 2022.
Structural Reforms: • Liberalize the labor market • Improve business environment • Deepen international integration	• Liberalization of frontier workers has been helpful in the context of a tight labor market. • A labor market reform is being discussed in the parliament. • The government and the EU have speeded up the association agreement. • The agenda 2030 will include reforms to boost the business environment and address infrastructure needs

Annex III. External Sector Assessment

The external position of the Republic of San Marino in 2021 was moderately weaker than implied by fundamentals and desirable policy settings. While significant data weaknesses call for caution, both the Current Account (CA) gap and real effective exchange rate (REER) Index models suggest an overvaluation. Along with other structural impediments, improving competitiveness remains a key challenge for San Marino.

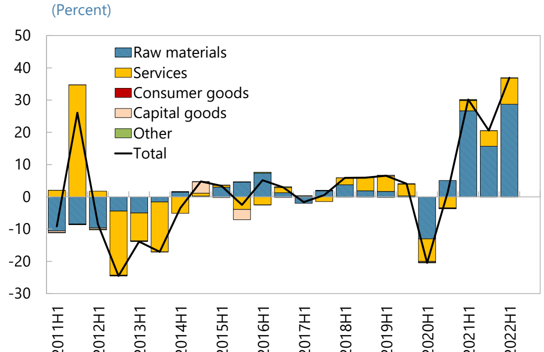
1. **In 2021, the current account (CA) continued recovering, driven by favorable external conditions.** The CA surplus expanded from 2.8 percent to 4.5 percent of GDP due to: (i) a robust recovery of the Italian economy; (ii) supply chain disruptions and higher transportation costs that temporarily affected Asian export-competitors; and (iii) the easing of covid lockdowns that allowed a pick-up in tourism. While data weaknesses call for caution[1], the 2021 CA surplus improvement was attributed to higher trade balance of goods and services. Both exports and imports grew about 22 percent, showing a robust recovery since the second half of 2021, in particular, in the manufacturing and tourism sectors.

Current Account
(Percent of GDP)



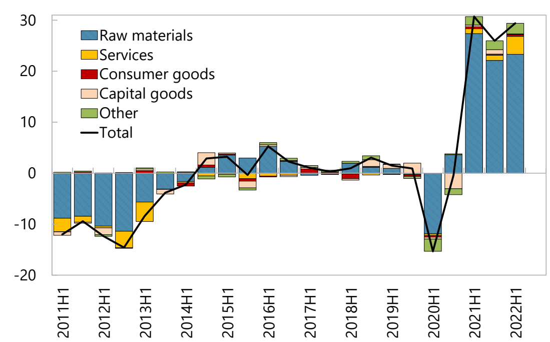
Sources: Country authorities; and IMF staff estimates.

Exports: Contribution to Growth
(Percent)



Sources: Sammarinese authorities, and IMF staff estimates.

Imports: Contribution to Growth
(Percent)



Sources: Sammarinese authorities, and IMF staff estimates.

2. **The financial account outflows were cushioned by the government issuance of a Eurobond in early 2021.** The Eurobond issuance allowed to repay short-term external debt and injected liquidity in the banking system, which ended in the central bank reserves. San Marino's gross international reserves (GIR) increased from €637 to €843 million between 2020 and 2021. Thus, GIR reached about 101 percent of the ARA metric.[2] This positive performance was a result of SDR allocation (about €60 million), and the rest is mostly attributed to higher banks deposits at the

[1] The authorities released revised BOP statistics in early 2021, correcting 2017–19 data.

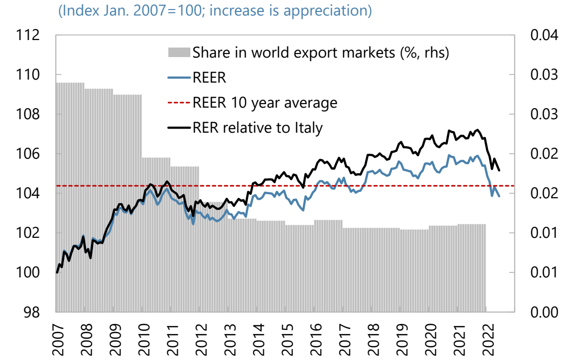
[2] The team calculated an ARA metric that consider special features of the San Marino economy, which well above the standard ARA. The team-ARA is estimated at €837 million while the standard ARA methodology implies an ARA of €472 million.

CBSM. The net international investment position (IIP) remained high, at 268 percent of GDP in 2021, but this figure may be overestimating the actual IIP since a large share of bank-loans to nonresidents are NPLs.

3. **San Marino's export market share has been stable for almost a decade, after declining considerably in the aftermath of the Global Financial Crisis (GFC).** Up until 2013, the country lost about two-thirds of its world export market share compared to the pre-GFC period due to a weak recovery in Italy, which contributed to a significant reduction in export of goods, including manufacturing. The loss in export market share occurred simultaneously with a prolonged appreciation of the REER on account of a persistent, positive inflation and labor costs differential vis-à-vis Italy and decline in labor productivity. Export growth since then has just kept market shares constant suggesting that competitiveness remains a key challenge. Moreover, San Marino continues to lag peers on regulation for starting a business, enforcing contracts, resolving insolvency, protecting minority investors, and dealing with construction permits.

CPI-Based REER and Export Market Share

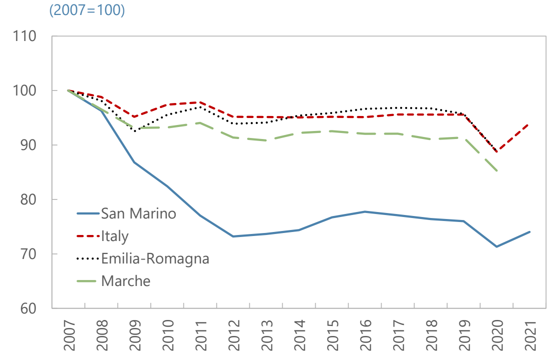
(Index Jan. 2007=100; increase is appreciation)



Sources: Sammarinese authorities, Haver, IFS, and IMF staff.

Real GDP per Employee

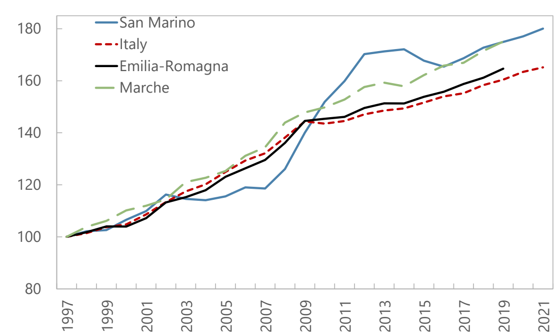
(2007=100)



Sources: Sammarinese authorities, Italian authorities, and IMF staff

Unit Labor Cost- Wages

(1997=100)



Sources: Sanmarinese authorities, Italian authorities, and IMF staff estimates.

4. **Both the CA and REER index models point to a real exchange rate overvaluation, although the models' fit for San Marino is poor.**

- **Current account approach:** Based on the EBA-lite approach, the estimated 2021 CA norm and the implied REER gap stood at about -6.1 percent of GDP and 8.4 percent, respectively. The high CA norm and REER overvaluation primarily reflect the relatively high net foreign asset position[3] of the economy relative to its key trading partners. However, these estimates should

[3] The stock of NIIP stood at 268 percent of GDP as of end-2021, of which 92 percent of GDP was related to banks and 154 percent attributable to other financial and nonfinancial corporations, households, and Nonprofit Institutions Serving Households (NPISHs).

be taken with caution given the model's poor fit for San Marino, and data weaknesses, which limit the ability to assess the REER elasticity with high confidence. As in the last assessment (i) we followed the EBA-Lite tool guidance and re-estimated San Marino' fixed effect since it is no more included in the EBA-Lite sample; and (ii) re-estimated the elasticity to account for the high share of re-exports in manufacturing exports (manufacturing imports represent about 65 percent of manufacturing exports). However, in this assessment, the EBA-Lite model regressions have been updated implying small changes in the coefficients and variables included. Moreover, the policy gaps are small and the cyclical adjustment to account for the temporary impact of the pandemic for 2021 is assumed at zero.

- **REER index model:** In contrast with the CA gap approach, the REER appears to be overvalued by only 2.4 percent (corresponding to a CA gap of -1.8 percent), suggesting that the REER is moderately weaker than that implied by fundamentals. This estimate is similar to the overvaluation in the 2021 Article IV consultation.

Model Estimates for 2021
(In percent of GDP)

	CA model 1/	**REER model** 1/
	(in percent of GDP)	
CA-Actual	**4.5**	
Cyclical contributions (from model) (-)	-0.3	
COVID-19 adjustor (-) 2/	0.0	
Additional temporary/statistical factors (-)	0.0	
Natural disasters and conflicts (-)	-0.2	
Adjusted CA	**5.0**	
CA Norm (from model) 3/	**11.1**	
Adjustments to the norm (-)	0.0	
Adjusted CA Norm	**11.1**	
CA Gap	**-6.1**	**-1.8**
o/w Relative policy gap	1.0	
Elasticity	-0.7	
REER Gap (in percent)	**8.4**	**2.4**

1/ Based on the EBA-lite 3.0 methodology
2/ No additional impact for COVID
3/ Cyclically adjusted, including multilateral consistency adjustments.

5. **Staff assess San Marino's external position as moderately weaker than implied by fundamentals and desirable policy settings.** Given the poor fit of the CA approach for San Marino, staff based its assessment on the IREER model which points to a moderate overvaluation and an external position that is moderately weaker than that implied by fundamentals and desirable policies. This assessment is also supported by the recent improvement in external (liquidity) buffers for the economy as a whole and the progress made to restore the viability of the banking sector. In particular, structural reforms continue to be crucial to restore the external competitiveness and reverse the significant reduction of exports' market share observed in the aftermath of the global financial crisis.

6. **The risks ahead are significant, so strong reserves remain critical.** The deterioration in the global external context due to the higher energy prices and the faster global monetary tightening imply significant risks for San Marino in 2023–24. First, higher energy prices will reduce the CA surplus. Second the increase in global interest rates can foster capital outflows as domestic investors and banks look for yield. Finally, as global interest rates increase, and international capital markets become more volatile, international investors can become more risk averse implying higher rollover risk for external debt.

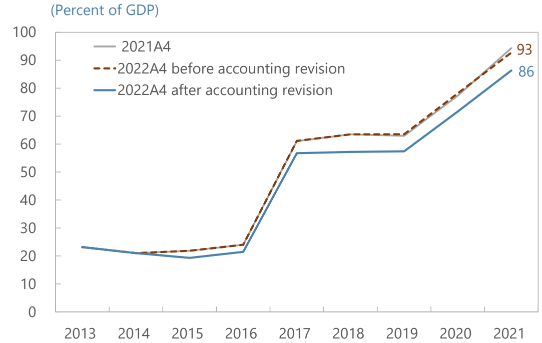
Annex IV. Debt Sustainability Analysis

Public debt is estimated to reach almost 84 percent of GDP at the end of 2022. In the baseline scenario, public debt is projected to slowly decline due to the favorable impact of the economic recovery, higher medium-term GDP deflator inflation, and partial consolidation efforts. However, there are significant risks to the baseline associated with uncertainty over the impact of the energy crisis and future growth, and large gross financing needs. Thus, the declining path of public debt is not robust to most shocks.

1. **San Marino's public debt remains high.** After increasing to €1276 million in 2021 (86 percent of GDP) from €969 in 2020 (72 percent of GDP), public debt edged up (further) in 2022 by €50 million to reach €1,326 million (84 percent of GDP). However, the acceleration in nominal GDP allowed debt to decline from 86 to 84 percent of GDP between 2021 and end-July 2022.

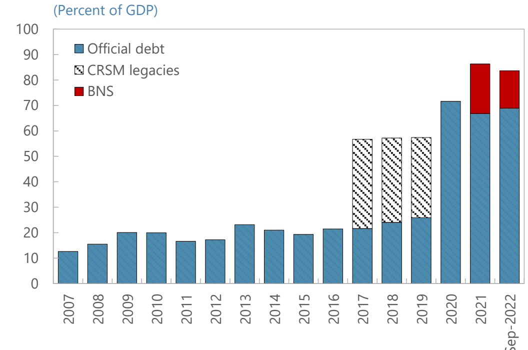
2. **The coverage of the fiscal accounts for debt sustainability in San Marino consists of the consolidation of the central government, pension fund and former BNS.** As argued in the previous staff report,[1] official debt in San Marino has not traditionally recognized the full extent of fiscal liabilities toward the banking sector. Therefore, staff adopted a broader coverage of the public sector accounts: the consolidated government, which includes the consolidated debt of the budgetary government, the social security fund, and the former BNS. For the debt sustainability analysis, the deficit of the consolidated government is computed as the sum of the central government (net of transfers to the pension fund) and the balance of the pension funds (net of government transfers). Thus, pension fund deposits in the former Banca Credito Industriale Sammarinese (Banca CIS) are no longer included in the stock of public debt, but their repayment is part of the transfers from the central government to the pension fund. After the reclassification and consolidation of general government's liabilities, the public debt at end-2021 is estimated at 86 percent of GDP. This is below earlier projections by around 6 percent of GDP explained by a one-off adjustment in some liabilities previously reported as payable accounts but that were already reported as debt. The authorities identified this double counting of some liabilities as part of ongoing efforts to strengthen debt management.

San Marino: Public Debt Revision
(Percent of GDP)



Sources: Sammarinese authorities, and IMF staff estimates.

Public Debt
(Percent of GDP)



Sources: Sammarinese authorities; and IMF staff estimates.

[1] See Annex III "Republic of San Marino—Staff Report for the 2021 Article IV Consultation."

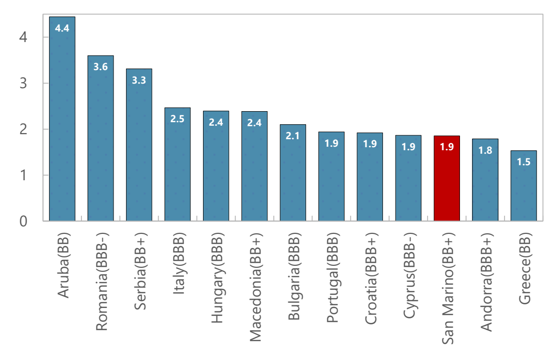
3. **While a large part of public debt is irresponsive to interest rate volatility, debt is highly vulnerable to rollover risk in the near term.** Only 8 percent of the debt is at variable interest rates and at the end of 2021, 60 percent of the debt was nonmarketable with low interest rates and long-term maturities.[2] As a result, the implicit interest rate on government debt has been low compared to countries with similar credit ratings. At the same time, the maturity of the Eurobond in February 2024, will increase overall gross financing needs to 30 percent of GDP. This high gross financing needs would take place in a challenging context, as San Marino is building fiscal buffers and global financial markets are volatile as interest rates are increasing. However, markets spread on Sammarinese Eurobond have been stable.

Public Debt Structure, 2021

	(Million euros)	Percent
External	**350**	**27.5**
External loans	10	0.8
Eurobonds	340	26.7
Domestic	**925**	**72.5**
Dom. loans	74	5.8
Dom. Bonds: Market	84	6.6
Dom. Bonds: Perpetual bonds	456	35.7
Payable accounts	24	1.9
BNS-Bonds	204	16.0
BNS others	84	6.6
Total	**1,276**	**100.0**
of which nonmarket[1]	767	60.1

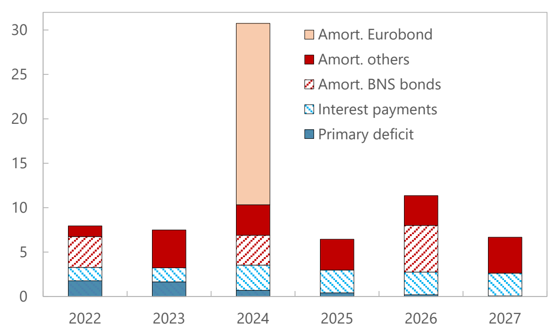
[1]Include payable accounts, perpetual bonds, BNS bonds, and BNS other liabilities.

Implicit Interest Rate of Government Debt, 2022
(Percent)



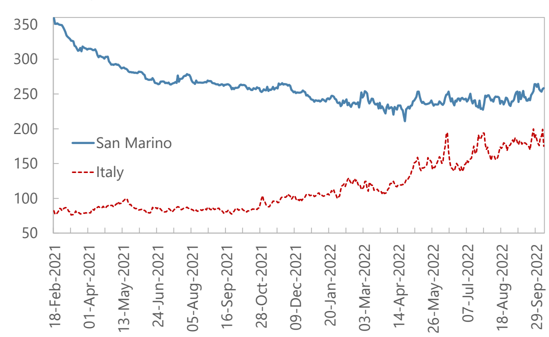
Sources: IMF staff estimates.

San Marino: Gross Financing Needs
(Percent of GDP)



Sources: IMF staff estimates.

Sovereign Spreads
(Basis points)



Sources: IMF staff estimates.

4. **The authorities relied on the domestic market to meet financing needs in 2022, but external funding will be needed to rollover the Eurobond next year.** The government issued €50 million of domestic bonds at 0.8 percent with one-year maturity and plans to borrow €20 million (more) from domestic banks at 10-year maturity by end-2022. The government is developing the domestic bond market taking advantage of the high liquidity and risk aversion of domestic banks. In addition, €55 million of bonds from BNS (maturing in 2022) were converted into

[2] Nonmarketable debt includes CRSM's perpetual bond with 1.75 percent coupon, BNS bonds with 0.1 percent coupon, and other accounts payable.

government bonds with a 1 percent interest and a 10-year maturity. However, refinancing the Eurobond, a key priority for San Marino, will require external funding.

5. Under the baseline, public debt is projected to moderately decline over the medium-term. The public debt is projected to be around 83 percent of GDP by the end of the forecast horizon, but with social security deposits being drawn down at an increasingly faster pace given large projected pension fund deficits. The pension funds' assets will decline from 28 to 22 percent of GDP by 2027. In the baseline scenario, real GDP growth is projected at around 3.5 percent in 2022, and after a slowdown in 2023, it stabilizes around potential growth (1.3 percent). Under current policies, the central government primary balance is projected to improve to -2.8 percent of GDP in 2022 from -16.4 percent in 2021 as bank support declines. Improvements are forecasted in 2023 as the authorities' index of public wages and pensions to private wages and eliminate one-off expenses. As a result, the consolidated primary balance improves to about 0.2 percent by 2027. While gross financing needs are around 9½ percent of GDP in 2023, they jump to about 30 percent of GDP mostly due to amortization of the Eurobond in 2024.

Key DSA Assumption
(Percent)

	2020	2021	2022	2023	2024	2025	2026
Real GDP Growth (percent)							
2022A4	-6.7	8.3	3.5	0.2	1.0	1.3	1.3
2021A1	-7.3	5.5	3.8	1.5	1.3	1.3	1.3
GDP deflator change (percent)							
2022A4	0.4	0.9	3.5	2.2	1.6	1.8	1.9
2021A1	1.2	1.5	1.5	1.2	1.3	1.3	1.4
Primary deficit (percent of GDP)							
2022A4	38.1	16.4	2.8	1.6	0.4	-0.1	-0.2
2021A1	38.0	18.1	1.8	1.0	1.0	0.9	1.3
Implicit interest rates (percent)							
2022A4	1.5	3.4	1.9	1.9	2.0	2.7	2.7
2021A1	1.5	3.1	1.9	1.9	2.8	2.8	2.8

Source: IMF staff estimates.

6. While global interest rates are higher than in the previous DSA, the impact on the implicit government interest rate is moderate. Following large domestic issuances in 2022, there are moderate short-term issuances in the near term which reduce interest rates for 2022–23. At the same time, the large share of debt at fixed interest rates combined with long maturities help keep effective interest rates low. Finally, the previous DSA was already assuming a sharp increase in interest rates. Under the baseline, the Eurobond is rolled over with a new issuance featuring 5-year maturity and a coupon of about 6 percent (compared with 5 percent assumed in the 2021 DSA). The sensitivity of the path of debt to the assumed interest rate on the Eurobond is small. If the interest rate on the Eurobond is 8 percent, the debt to GDP would increase by 1.5 percent relative to the baseline to reach 84 percent of GDP in 2027. The baseline assumes that market conditions allow an early issuance of the new Eurobond in 2023 with a buyback of about half of the Eurobond maturing in 2024. As a result, debt-to-GDP will go above 94 percent and then decline to the baseline path when the other half of the Eurobond is repaid in 2024.

7. Under most alternative scenarios, debt dynamics deteriorate. While the level of public debt will be elevated, debt dynamics under the baseline are favorable. Both the historical and constant primary balance scenarios result instead in explosive debt dynamics. The historic scenario is heavily biased by the extent of bank support provided by the government in the past (which included a gradual recognition of CRSM legacy losses that have now fully incorporated into debt) and the lackluster growth experienced over the last decade, which have both led to large and sustained deficits over the years. The constant primary balance scenario does not account for improvements due to the pension reform in the next years.

8. Standardized stress tests reveal that the baseline path of public debt is not robust to moderate shocks that would lead to an increase in public debt. The standardized shocks confirm that public debt dynamics are sensitive to shocks to growth, materialization of contingent liabilities and combined macro-fiscal shocks.

- *Real growth shock.* Real GDP growth is assumed to decline by one standard deviation declining to around -4 percent in 2023–24. The primary balance deteriorates therefore to -3.5 percent by 2024 (from a -3.1 percent in the baseline), which result in debt increasing to 100 percent of GDP by then and marginally declining afterwards.

- *Combined macro-fiscal shock.* The scenario combines the above growth shock, an interest rate shock (increase in spreads by 300 basis points) and a primary balance shock (failure to achieve half of the planned adjustment under the baseline) which results in an increase in the level of public debt to 105 percent of GDP by 2023 that remain high.

- *Contingent liability customized shock.* This scenario envisages potential risks associated with the implementation of the AMC,[3] calibrated to cost about 15 percent of GDP, and the use of tax credits, which could cost an additional 9 percent of GDP. Under this scenario, public debt goes above 117 percent of GDP by 2023 and then marginally declines.

9. Managing risks of high public debt requires a credible fiscal adjustment and improved debt management capacity. As the current path of debt is not robust to shocks, it is critical to rebuild fiscal buffers through a more ambitious fiscal consolidation that should target a primary surplus (net of bank support) of 2.5 percent of GDP. Implementing fiscal reforms cannot be further delayed, as they take time to be implemented and deliver. In addition, it is key to take advantage of the high inflation context that facilitates the consolidation of spending. In the meantime, maintaining higher short-term liquidity buffers is priority, while the government should diversify by developing the domestic bond market. Improving debt management capacity and strengthening the banking system to reduce fiscal risks remain essential.

10. San Marino's gross external debt is set to decline on the back of continued moderate, capital outflows. San Marino's gross external debt stood at 96 percent of GDP in 2021, where

[3] Fiscal costs related to the AMC operations could be reflected in the baseline if the level of guarantees is not consistent with expected recovery values.

deposit liabilities of deposit-taking corporations accounted for the largest component. With continued capital outflows, including from the banking system, gross external debt is projected to remain on a downward trajectory over the medium term, reaching a level of 78 percent of GDP by 2027. All else equal, lower growth, a deterioration in the current account, and a slower price growth relative to that in key trading partners (real exchange rate depreciation) would result in a higher trajectory of external debt relative to the baseline. The analysis is subject to several caveats reflecting data limitations including lack of FDI liabilities and the short external sector historical data.

Figure IV.1. San Marino: Public Sector Debt Sustainability Analysis—Baseline Scenario

(In percent of GDP unless otherwise indicated)

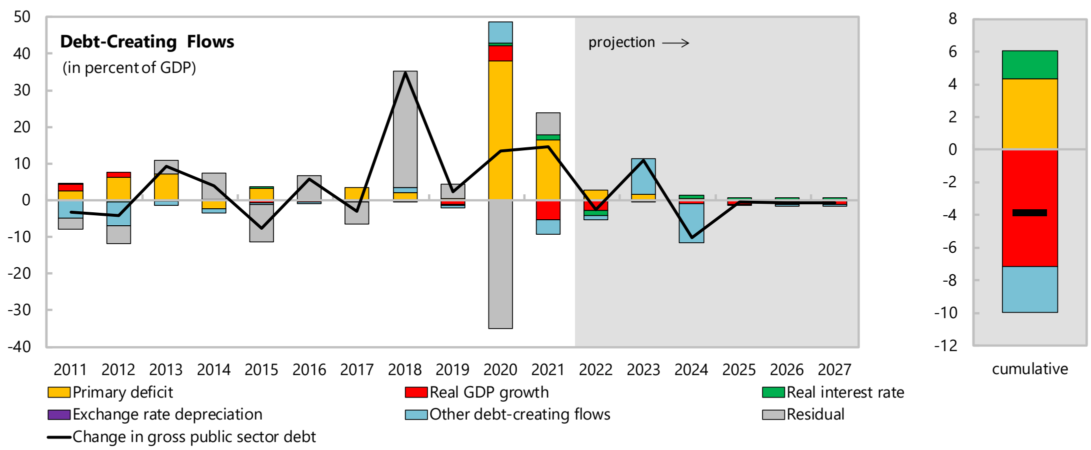
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2011-2019 [2/]	2020	2021	2022	2023	2024	2025	2026	2027
Nominal gross public debt	28.2	71.6	86.3	83.7	94.6	84.5	84.1	83.3	82.5
Public gross financing needs	3.6	40.4	39.3	8.9	18.0	21.1	6.6	11.7	9.3
Real GDP growth (in percent)	-0.9	-6.7	8.3	3.5	0.2	1.0	1.3	1.3	1.3
Inflation (GDP deflator, in percent)	1.2	0.4	0.9	3.5	2.2	1.6	1.8	1.9	1.8
Nominal GDP growth (in percent)	0.3	-6.3	9.2	7.2	2.4	2.7	3.1	3.2	3.2
Effective interest rate (in percent) [4/]	1.0	1.5	3.1	1.9	1.9	2.8	2.8	2.8	2.8

As of October 11, 2022		
Sovereign Spreads		
EMBIG (bp) 3/		258
5Y CDS (bp)		n.a.
Ratings	Foreign	Local
Moody's	n.a.	n.a.
S&Ps	n.a.	n.a.
Fitch	BB	BB

Contribution to Changes in Public Debt

	Actual			Projections							
	2011-2019	2020	2021	2022	2023	2024	2025	2026	2027	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	4.2	13.5	14.7	-2.6	10.9	-10.1	-0.5	-0.8	-0.8	-3.9	
Identified debt-creating flows	1.0	48.6	8.6	-2.6	10.9	-10.1	-0.5	-0.8	-0.8	-3.9	
Primary deficit	2.6	38.1	16.4	2.8	1.6	0.4	-0.1	-0.2	-0.1	4.4	-0.7
Primary (noninterest) revenue and grants	33.1	31.9	32.0	31.5	30.9	31.7	32.3	32.4	32.5	191.3	
Primary (noninterest) expenditure	35.6	70.0	48.3	34.3	32.5	32.1	32.2	32.1	32.4	195.7	
Automatic debt dynamics [5/]	0.1	4.9	-4.0	-4.3	-0.4	0.1	-0.3	-0.3	-0.3	-5.4	
Interest rate/growth differential [6/]	0.1	4.9	-4.0	-4.3	-0.4	0.1	-0.3	-0.3	-0.3	-5.4	
Of which: real interest rate	0.0	0.7	1.4	-1.4	-0.2	1.0	0.8	0.7	0.8	1.7	
Of which: real GDP growth	0.1	4.1	-5.4	-2.9	-0.2	-1.0	-1.1	-1.1	-1.0	-7.2	
Exchange rate depreciation [7/]	0.0	0.0	0.0	…	…	…	…	…	…	…	
Other identified debt-creating flows	-1.6	5.7	-3.7	-1.1	9.6	-10.5	-0.1	-0.3	-0.4	-2.8	
Deposit Drawdown (+) (negative)	-1.6	5.7	-3.7	-1.1	9.6	-10.5	-0.1	-0.3	-0.4	-2.8	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	3.2	-35.1	6.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi (1+g)$ and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

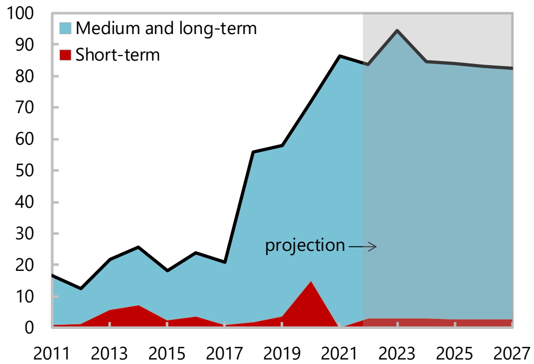
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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

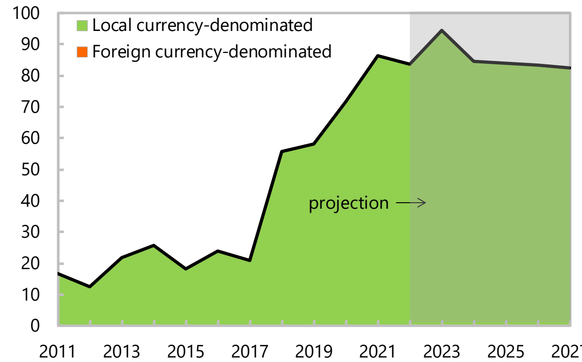
Figure IV.2. San Marino: Public Debt Sustainability Analysis—Composition of Public Debt and Alternate Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



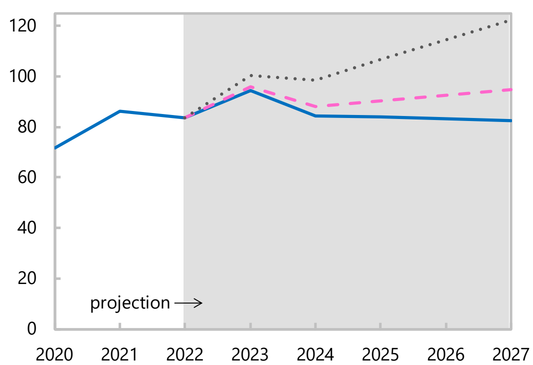
By Currency
(in percent of GDP)



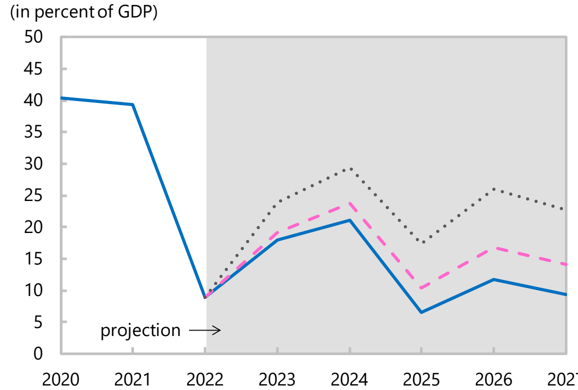
Alternative Scenarios

Baseline   Historical   Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)

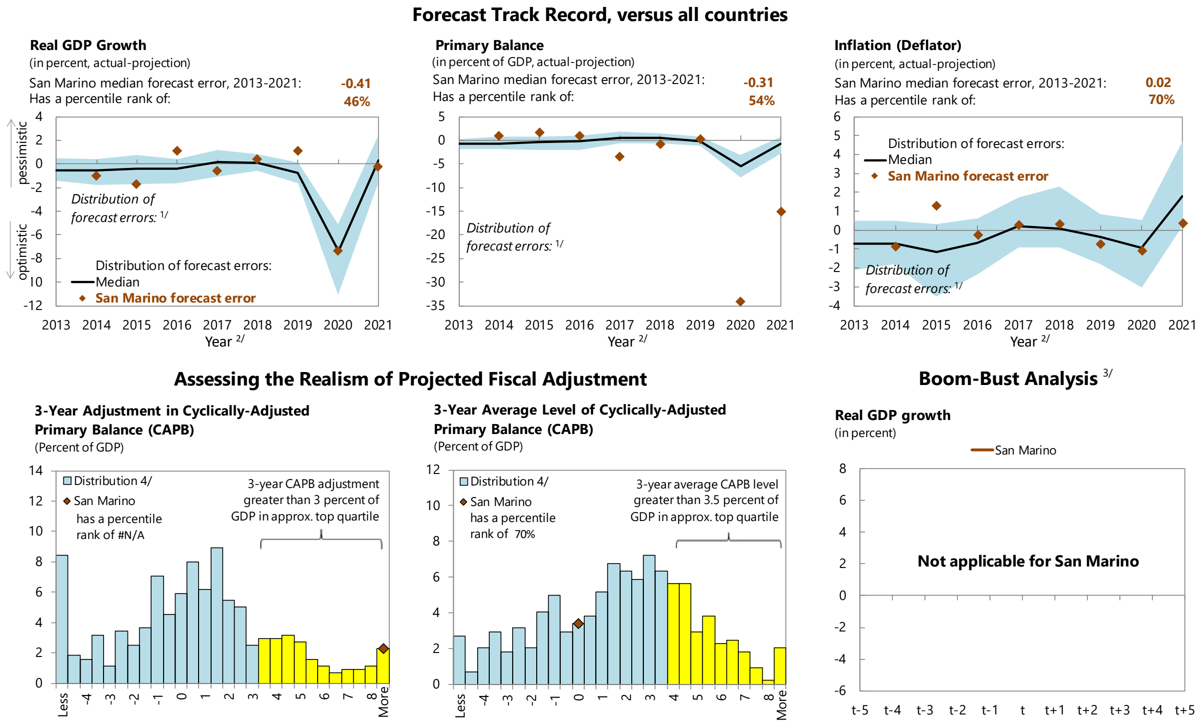


Underlying Assumptions
(in percent)

Baseline Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary Balance	-2.8	-1.6	-0.4	0.1	0.2	0.1
Effective interest rate	1.9	1.9	2.8	2.8	2.8	2.8
Constant Primary Balance Scenario						
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary Balance	-2.8	-2.8	-2.8	-2.8	-2.8	-2.8
Effective interest rate	1.9	1.9	2.8	2.8	2.8	2.8

Historical Scenario	2022	2023	2024	2025	2026	2027
Real GDP growth	3.5	0.2	0.2	0.2	0.2	0.2
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary Balance	-2.8	-7.5	-7.5	-7.5	-7.5	-7.5
Effective interest rate	1.9	1.9	2.8	2.8	2.8	2.7

Figure IV.3. San Marino: Public Debt Sustainability Analysis—Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes all countries, percentile rank refers to all countries.

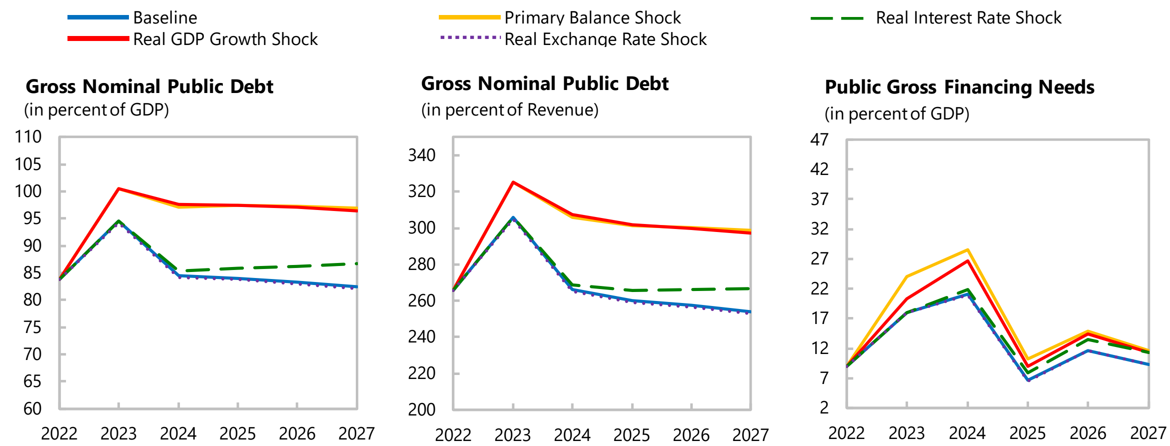
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for San Marino, as it meets neither the positive output gap criterion nor the private credit growth criterion.

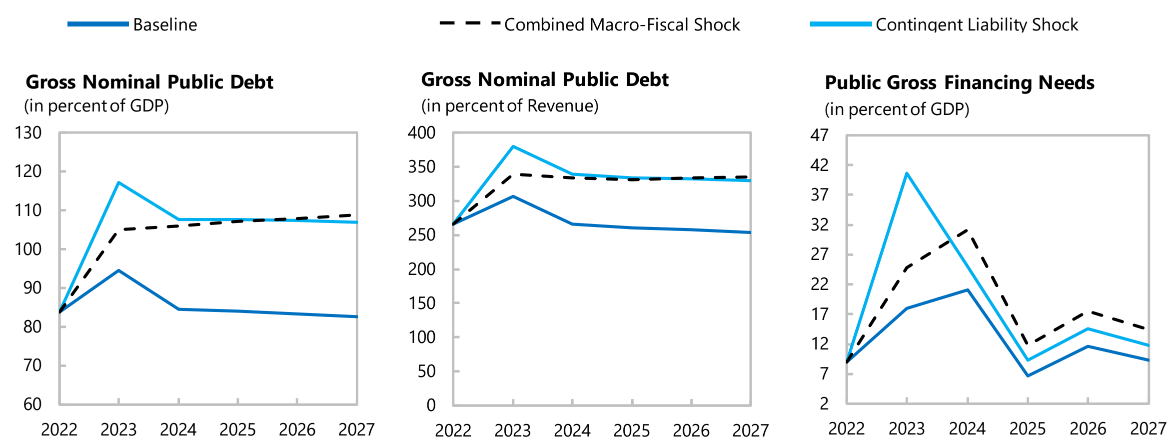
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure IV.4. San Marino: Public Debt Sustainability Analysis—Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary balance	-2.8	-7.6	-6.3	0.1	0.2	0.1
Effective interest rate	1.9	1.9	3.4	3.6	3.5	3.5
Real Interest Rate Shock						
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary balance	-2.8	-1.6	-0.4	0.1	0.2	0.1
Effective interest rate	1.9	1.9	3.6	4.0	4.1	4.4
Combined Shock						
Real GDP growth	3.5	-4.3	-3.5	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary balance	-2.8	-7.6	-6.3	0.1	0.2	0.1
Effective interest rate	1.9	1.9	3.9	4.3	4.4	4.7

Real GDP Growth Shock	2022	2023	2024	2025	2026	2027
Real GDP growth	3.5	-4.3	-3.5	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary balance	-2.8	-3.2	-3.5	0.1	0.2	0.1
Effective interest rate	1.9	1.9	3.0	3.2	3.2	3.2
Real Exchange Rate Shock						
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.6	1.6	1.8	1.9	1.8
Primary balance	-2.8	-1.6	-0.4	0.1	0.2	0.1
Effective interest rate	1.9	1.9	2.8	2.8	2.8	2.8
Contingent Liability Shock						
Real GDP growth	3.5	0.2	1.0	1.3	1.3	1.3
Inflation	3.5	2.2	1.6	1.8	1.9	1.8
Primary balance	-2.8	-24.2	-0.4	0.1	0.2	0.1
Effective interest rate	1.9	2.0	3.2	3.3	3.3	3.3

Source: IMF staff.

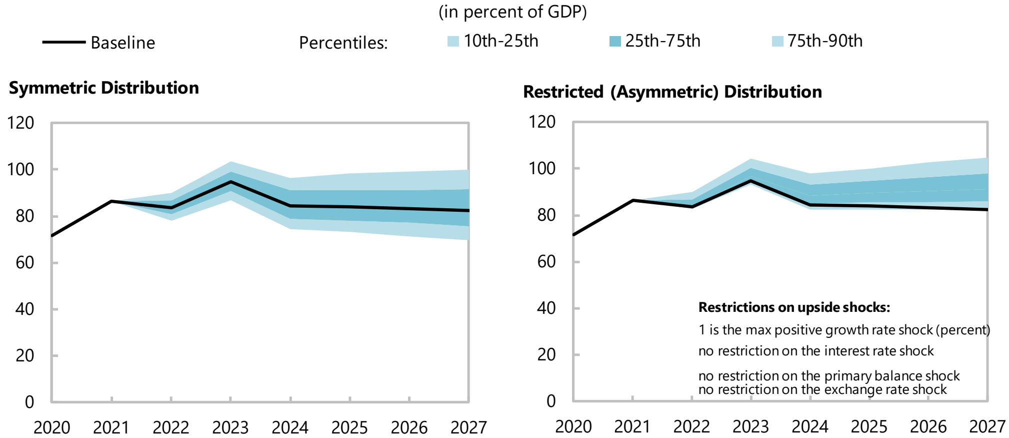
Figure IV.5. San Marino: Public Debt Sustainability Analysis—Risk Assessment

Heat Map

Debt level 1/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs 2/	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile 3/	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

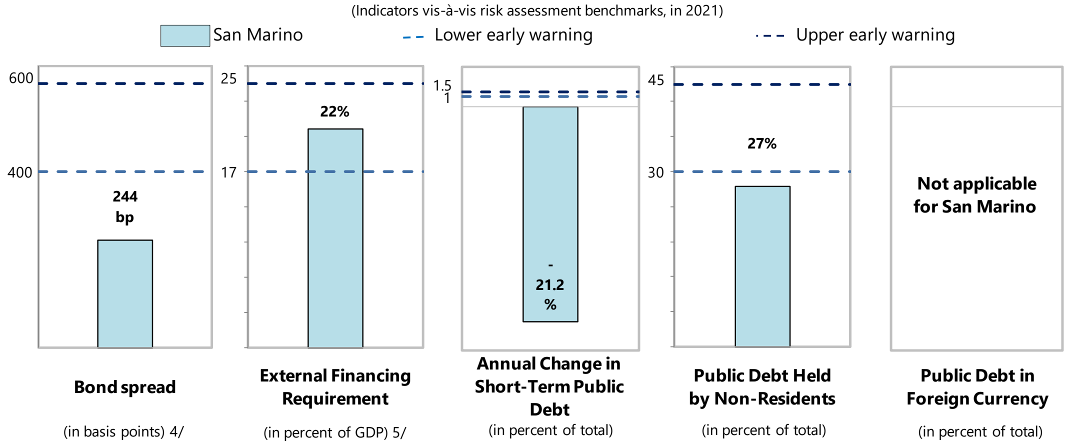
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2021)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

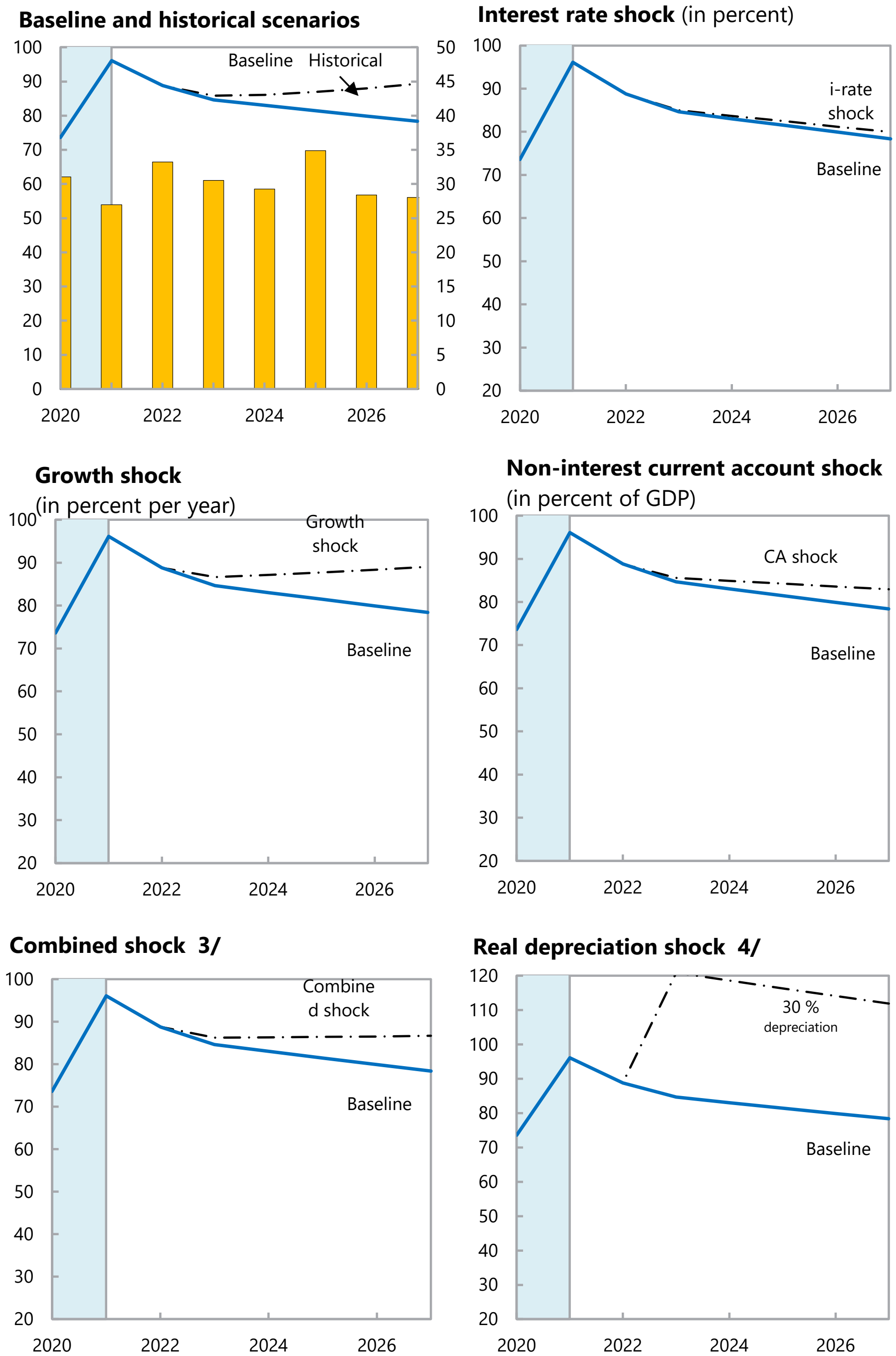
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 13-Jul-22 through 11-Oct-22.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure IV.6. San Marino: External Debt Sustainability: Bound Tests[1, 2]
(External debt in percent of GDP)



Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2020.

Table IV.1. San Marino: External Debt Sustainability Framework, 2019–27

(In percent of GDP unless otherwise indicated)

	Actual					Projections						
	2019	2020	2021			2022	2023	2024	2025	2026	2027	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	**69.0**	**73.6**	**96.1**			**88.8**	**84.7**	**83.0**	**81.5**	**79.9**	**78.4**	**-0.8**
2 Change in external debt	-7.5	4.6	22.5			-7.3	-4.1	-1.6	-1.6	-1.6	-1.5	
3 Identified external debt-creating flows (4+8+9)	0.7	-5.7	-2.2			-6.5	-3.7	-1.8	-1.8	-1.8	-1.8	
4 Current account deficit, excluding interest payments	-2.9	-3.7	-6.4			-2.9	-2.7	-2.9	-2.9	-2.9	-2.9	
5 Deficit in balance of goods and services	-11.3	-13.4	-15.7			-10.8	-9.1	-8.9	-9.1	-9.0	-9.0	
6 Exports	159.5	157.9	178.1			179.7	172.2	170.9	170.7	170.4	170.1	
7 Imports	148.2	144.5	162.5			168.8	163.1	162.0	161.6	161.3	161.2	
8 Net non-debt creating capital inflows (negative)	0.6	0.1	0.3			0.2	0.2	0.2	0.2	0.2	0.2	
9 Automatic debt dynamics 1/	3.1	-2.1	3.9			-3.8	-1.2	0.8	0.9	0.9	0.9	
10 Contribution from nominal interest rate	0.9	0.9	2.2			1.6	2.0	2.0	1.9	1.9	1.9	
11 Contribution from real GDP growth	-1.3	-1.3	4.9			-5.4	-3.2	-1.2	-1.0	-1.0	-1.0	
12 Contribution from price and exchange rate changes 2/	3.5	-1.6	-3.3			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	-8.2	10.3	24.7			-0.8	-0.5	0.2	0.2	0.2	0.3	
External debt-to-exports ratio (in percent)	43.2	46.6	53.9			49.4	49.2	48.6	47.7	46.9	46.1	
Gross external financing need (in billions of US dollars) 4/	0.5	0.5	0.5			0.6	0.5	0.5	0.7	0.6	0.6	
in percent of GDP	33.8	31.1	27.0	10-Year	10-Year	33.2	30.5	29.3	34.9	28.4	28.0	
Scenario with key variables at their historical averages 5/						**88.8**	**85.9**	**86.1**	**86.9**	**88.0**	**89.4**	**3.5**
Key Macroeconomic Assumptions Underlying Baseline				Historical Average	Standard Deviation							
Real GDP growth (in percent)	1.7	2.0	-6.5	-2.0	4.6	5.5	3.7	1.5	1.3	1.3	1.3	
GDP deflator in US dollars (change in percent)	-4.4	2.3	4.6	-0.1	6.6	-7.6	-0.9	1.9	2.4	2.5	2.5	
Nominal external interest rate (in percent)	1.1	1.3	2.9	1.5	0.8	1.6	2.3	2.5	2.4	2.4	2.4	
Growth of exports (US dollar terms, in percent)	-3.4	-5.5	27.8	5.9	13.6	-1.6	-1.5	2.6	3.6	3.6	3.7	
Growth of imports (US dollar terms, in percent)	-5.6	-6.9	27.4	9.2	15.6	1.4	-0.7	2.7	3.4	3.7	3.7	
Current account balance, excluding interest payments	2.9	3.7	6.4	5.0	1.9	2.9	2.7	2.9	2.9	2.9	2.9	
Net non-debt creating capital inflows	-0.6	-0.1	-0.3	-0.2	0.3	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, e = nominal appreciation (increase in dollar value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.

6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

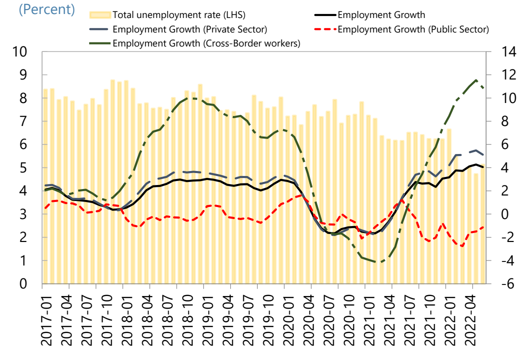
Annex V. Post-COVID Labor Market Rebound and Trends

San Marino's labor market has undergone some significant changes in the last two years with greater liberalization of frontier workers, more gender equality, higher participation rate and more formalized wage negotiation. The trade association and labor union are collectively negotiating a long due labor market reform to be implemented by the end of 2022, after almost a decade.

Labor Market Trends and Composition

1. **San Marino's employment gained momentum after the pandemic.** The year-on-year growth in employment declined across all sectors and gender due to covid. While private sector employment growth is back to pre-pandemic levels, public employment growth is at best sluggish. The overall rebound has been persistent for both male and female workers in the first half of 2022.

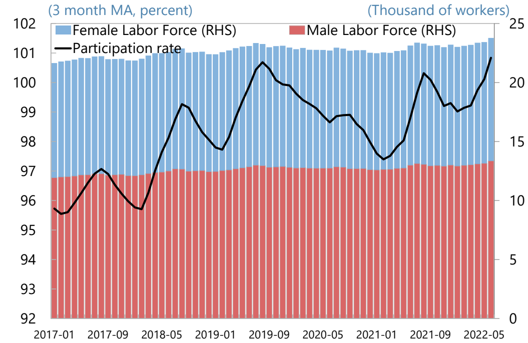
Employment Growth
(Percent)



Sources: Sammarinese authorities and IMF staff estimates.

2. **With a tight labor market in 2022, the reliance on cross-border workers has increased significantly.** San Marino's domestic unemployment rate is at its lowest level in the last decade with very high labor force participation rate. Despite this, businesses are facing difficulty in finding resident workers, which has led to lifting restrictions on cross-border workers introduced during covid thereby increasing the year-on-year growth in employment of cross-border workers to an unprecedented level. This liberalization of frontier workers has been welcomed by all the stakeholders and would continue going forward unless domestic unemployment rate increases beyond some pre-decided threshold.

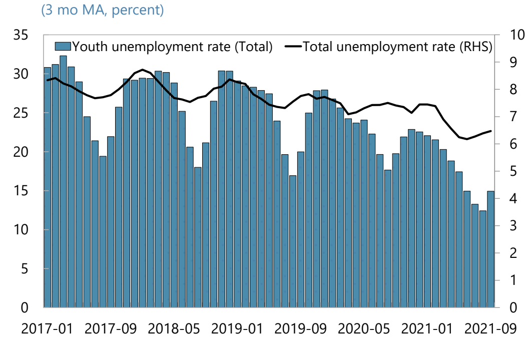
Participation Rate
(3 month MA, percent) (Thousand of workers)



Sources: Sammarinese authorities and IMF staff estimates.

3. **Youth have benefitted with a relatively higher decline in the unemployment rate since 2021.** This aligns with the age biased covid related health effects and sectoral asymmetry in employment rebound—with higher momentum gained by manufacturing, hospitality, and retail trade. The sectoral asymmetry becomes quite evident in the distinct seasonality of youth unemployment, driven by increases in employment during the summer.

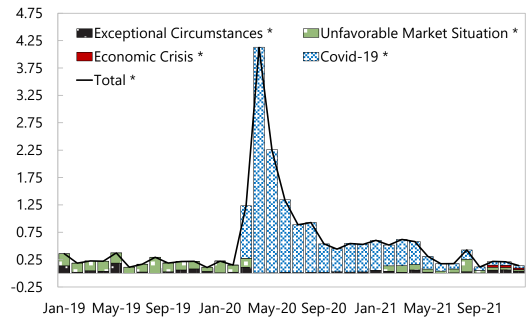
Youth Unemployment Rate
(3 mo MA, percent)



Sources: Sammarinese Authorities and IMF staff estimates.

4. The burden on wage guarantee fund is reduced, back to pre-pandemic levels. Consistent with the strong recovery of the labor market, the expenditure on supplemental wage scheme to protect employees from job losses due to the pandemic is no longer needed.

Wage Guarantee Fund
(million euros)

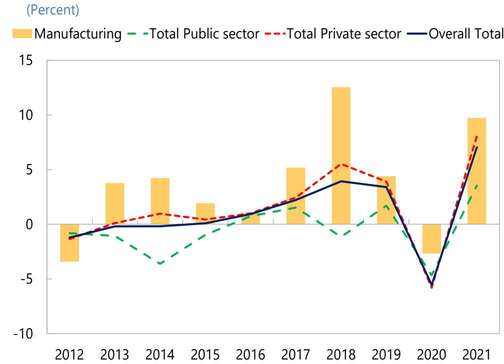


Sources: Sammarinese Authorities

New Collective Bargaining Agreement

5. The overall wage bill is rapidly growing especially so in the manufacturing sector. The booming labor market and increasing inflation have put upward pressure on the wage bill.

YoY Growth in Wages
(Percent)



6. A new collective wage bargaining agreement between the trade associations and labor unions over three years (2021–23) has been recently approved. The contract provides for an increase in paycheck of 5.4 percent over 2022–23 (1.5 percent from 1 June 2022, 1.5 percent from 1 August 2022, and 2.4 percent from January 2023). This is in addition to 0.6 percent increase in 2021 aggregating the total increase over three years to 6 percent. The agreement spans one third of all private sector employees. These prudent wage increases over the next few months, combined with the labor reform proposal (see Box V.1), should help moderate wage dynamics.

Box V.1. Key Measures of Labor Market Reform Proposal (2022)

The 2022 labor market reform consolidates all the labor market legislations and decrees under one umbrella reform. The job initiation and intermediation process is carried out by the ULPA-CFP (Office of employment and active policies and the professional training center), while the Labor Commission oversees labor market dynamics. Some of the key measures of the reform are:

- Incentives to facilitate reskilling from sectors in difficulty
- Reintegration of long term unemployed, job placement of people without professional experience. Active insertion of new professions and employees, encourage female employment
- Inclusion of frontier workers to all intents and purposes in the labor unions CGIL and CSDL
- Provision of temporary workers by a "contracting company" for a "user company" with fair treatment in salary, issuance of license to work, and appropriate insurance
- Decrease in the tenure of fixed term hiring from 18 to 12 months – automatic conversion to open ended employment at the end of the tenure unless firm chooses to end the contact at 10 days' notice.

Annual reporting by the commission to the great and general council on the state of employment

Annex VI. Improving Public Debt Management

A weak fiscal position and volatility of gross financing needs have highlighted the need to strengthen debt management. Limited fiscal space and the rollover of the Eurobond in 2024 make a compelling case for improved debt management in San Marino. This rollover occurs in the context of high public debt and in the absence of a comprehensive fiscal consolidation path over the medium-term. High and uneven gross financing needs due to Eurobond-rollover are not unique to San Marino.[1] A debt management strategy for San Marino requires improved debt management capacity and should be anchored in a broader medium-term fiscal strategy. This annex will review the debt management issues in small economies (section I), then focus on San Marino debt management (Section II) and finally simulate some debt strategies (III).

Debt Management in Small Economies

1. **Public debt management should ensure that the government's medium-term financing needs are met at the lowest possible cost and with a prudent degree of risk.** Public debt management is centered around a medium-term debt strategy and tries to raise awareness of the impact of government's financing requirements and debt levels on borrowing costs as well as potential risks. At the same time, it should also factor in short-term cash management considerations.

2. **A medium-term debt strategy (MTDS) is a plan[2] to achieve a desired composition of government debt, capturing the government's preferences regarding cost-risk trade-offs.**[3] The strategy identifies and explains the trade-offs between the costs and risks of alternative financing options. It considers the risks associated with foreign currency, short-term and variable interest rate borrowing, as well as the uncertainty regarding government's cash flows. A MTDS informs the decision on how to meet financing requirements, while considering constraints and risks. A MTDS can result in lower funding cost, as an effective and transparent strategy supports domestic debt market development. Furthermore, the lack of a strategy can lead to excessive focus on cost savings via short-term and variable interest rate debt, which can increase risks by exposing governments to changes in financial conditions.

3. **Sound debt management is key for a small country.** Small countries are less diversified, have a smaller base of domestic savings, and less developed financial systems. Therefore, they are more vulnerable to shocks. They also lack economies of scale in public administration—resulting in

[1] Several countries faced or will face this issue (e.g. Albania, Andorra, Cyprus, Macedonia, and Montenegro)

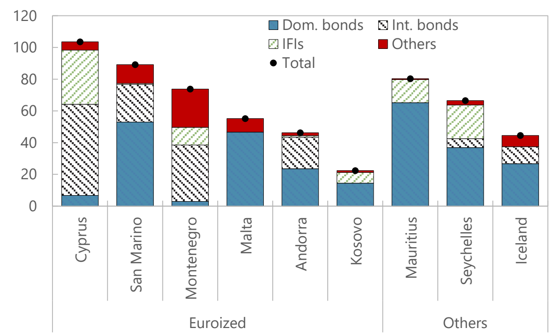
[2] In practical terms, a strategy is a combination of borrowing instruments to meet the gross financing needs.

[3] Trade-offs generally cover decisions among other: (i) issuing short term debt at low interest rates, but with higher refinancing risks against issuing long term debt with higher cost but lower refinancing risks; (ii) Issuing debt at fixed interest rates against variable interest rates; and (iii) similarly issuing debt domestically facing maturity and size constraints, against issuing debt externally with longer maturities and larger volumes.

high transaction cost—and face limited human capital that constraints debt management (Prasad and others 2013).[4]

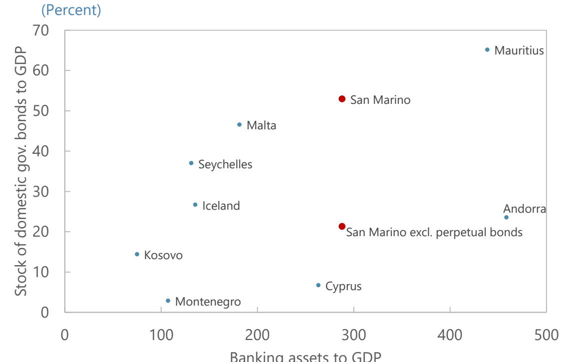
4. Managing the domestic-foreign funding trade-off is key for a small economy, but cross-country experience is mixed. In the near term, usually the trade-off between domestic versus foreign borrowing are determined by the development, or lack thereof, of a domestic debt market, private sector crowding-out considerations, and the credit ratings—proxy for institutional and economic performance. Domestic financial development and credit ratings diverge among regional peers or other small economies, and therefore the domestic-foreign funding is uneven across country comparators.

Government Debt, 2021
(Percent of GDP)



Sources: IMF staff estimates.

Banking Assets and Stock of Domestic Gov. Bonds
(Percent)



Sources: IMF staff estimates.

5. Relying on international bond issuances can provide longer-term funding, at the cost of greater refinancing needs and high transaction cost for small economies. International bond issuances allow countries to borrow longer-term. However, they demand large volume (at least €500 million) to ensure liquidity and attract investors. In most cases, such large volumes have bullet amortizations that pose significant challenges for a small country with limited debt management capacity and, generally, underdeveloped domestic debt markets as well as capacity constraints. Also, international issuances have a high transaction cost in terms of indirect costs (fees and issuance expenses) for infrequent issuers.

6. Relying on domestic markets can also be difficult for small countries. Domestic shallow markets tend to demand short-term government securities, which can create large rollover needs. Usually banks-dominated-markets demand shorter maturities following a ‘buy and hold’ approach. Some countries, facing high rollover risk from sizable short-term domestic debt, issued international bonds to diversify and extend maturities (e.g. Albania (2017), Andorra (2021)). In small economies, the domestic debt issuance is often discretionary, driven by the government’s short term cash need

[4] Staff at ministries of finance in small countries are usually limited and assigned multiple tasks. Therefore, they stretch their capacity to its limits. Similarly, as prospects of promotion are narrow, it hampers experts’ recruitment.

and an announcement to the market of the issuance can be made a few days before the actual issue date. This goes against the investor demand for predictability and results in higher borrowing costs.

Table VI.1. Selected Pros and Cons of Funding Sources

Pros	Cons
Domestic Funding	
+ Domestic bond market provides a durable source of financing + Allows smaller sizes and more frequent issuance + Facilitates domestic liquidity management and investment	- Absorption capacity of domestic market is limited - Large dependency on banks - Focus on short- and medium-term maturities in the absence of secondary market (i.e. limited liquidity) - Risk of crowding out private borrowers - Refinancing risk when the share of short-term debt is large
International Capital Market Funding (Eurobonds)	
+ Signal of "country strength" + Reduced refinancing risk due to longer maturities + Interest rate can be lower than domestic rate	- Refinancing risk: typical bullet structure means a large redemption at one time. - Fees add to total cost - Market discipline can be perceived as restrictive

Source: Based on Van der Wansen and others (2019).

7. **Nevertheless, developing a domestic bond market is important for small economies.** The domestic market is better suited to absorb the small amounts needed to cover cash management needs in small economies. Similarly, a deep and liquid domestic bond market can reduce debt service costs over the medium-term as liquidity premia embedded in the yields on government bonds declines.

Zooming into San Marino

8. **The Sammarinese medium-term debt strategy should ensure that the government's financing needs are met at the lowest possible cost over the medium-term.** The strategy should aim to reduce refinancing risk, develop a liquid domestic bond market, and keep access to international capital markets. To promote the domestic debt market, new issuances should be focused on fewer maturities (2 or 3) with emphasis on consolidating existing bonds by increasing its liquidity. Any strategy to develop the domestic debt market should factor in that long-term maturities can be more expensive and potentially less liquid initially. This strategy will evolve as the debt office and the market develop.

9. **San Marino should develop a debt management strategy that combines external and domestic funding.** The strategy should find the right balance between minimizing financing costs while reducing rollover and other risks, help develop the domestic debt market and ensure access to international capital markets. External debt could allow to extend maturities, while further developing the domestic debt market could benefit from sizable savings and a high ratio of bank assets to GDP and could help reduce large rollover spikes associated with international bonds. Furthermore, as a euroized economy, San Marino has no currency premium. While the development of a domestic debt market can eventually incentivize the repatriation of Sammarinese savings

abroad (120 percent of GDP), this will take time and require a consolidated market and competitive interest rates.

Table VI.2. Government and BNS Bonds, July 2022

	Outstanding July 2022 (Million euros)	Present Value[1] July 2022 (Million euros)	Interest rate (Percent)	Original maturity (Years)	Residual maturity (Years)	Issuance date	Maturity date
Total Bonds (I+II)	**1150.7**	**866.6**					
I. External bonds	**340.0**	**338.4**					
Eurobond 2024	340.0	338.4	3.25	3	1	24-Feb-2021	24-Feb-2024
II. Domestic bonds (a+b)	**810.7**	**528.2**					
a. Market bonds	**187.8**	**173.1**					
Bond 2026 (DD n.17/2016)	40.0	40.7	Euribor+1.5[2]	10	4	23-Mar-2016	23-Mar-2026
Bond 2026 (DD n.55/2016)	10.0	10.2	Euribor+1.5[2]	10	4	31-May-2016	31-May-2026
Bond 2029 (DD n.153/2019)	34.0	30.9	2.00	10	7	29-Nov-2019	29-Nov-2029
Bond 2023 (DD n.61/2022)	50.0	48.7	0.80	1	1	02-Jun-2022	02-Jun-2023
Bond 2032-BNS conversion (DD n.94/2022)	53.8	42.6	1.00	10	10	21-Jul-2022	21-Jul-2032
b. Nonmarketable bonds	**622.9**	**355.2**					
Perpetual Bond - CRSM	455.0	220.0	1.75	//	//	30-Dec-2020	//
Perpetual Bond - CBSM[3]	19.0	0.5	0.10	//	//	19-Jul-2021	//
Bonds former BNS	148.9	134.7					
BNS bond 2024	56.0	52.5	0.25	5	2	22-Jul-2019	20-Jul-2024
BNS bond 2026	92.9	82.2	0.35	7	4	22-Jul-2019	20-Jul-2026
Memoradum							
BNS bonds 2022 (pre-conversion to Bond 2032-BNS)	55.0	55.0					

[1] Present value is discounted at 3.5 percent based on the yield of the 30 year Italian government bond.
[2] Maximum 4.5 percent.
[3] Accounted in present value in the stock of debt as it does not amortize and interest payments is almost zero. Nominal value of the bond is 19 millions.
Source: IMF staff estimates based on country authorities.

10. San Marino's domestic banks have some room to absorb government bonds. In July 2022, total issued domestic bonds accounted for €811 million (53 percent of GDP) most of which were nonmarketable, such as CRSM's recapitalization perpetual bonds, CBSM or former BNS bonds. Banks' exposure to the government was €547 million (10 percent of banks' assets) suggesting banks can expand their portfolio of government bonds. Furthermore, banks can increase government bonds' demand with fresh funds. With the banking system growing in line with medium term nominal GDP[5], the banks would have new loanable funds for about €50 million per year. Given banks' high-risk aversion, banks can allocate about €20-30 million per year to buy government bonds while keeping the risk of crowding out private credit contained.

Gov. Domestic Bonds - Jul-2022

(Million euros)

Creditor	Total	Nonmarket	Market
Total	**811**	**605**	**207**
Banks	547	456	91
Others	264	149	115

Source: Country authorities and IMF staff estimates.

11. The domestic bond market liquidity can be supported by converting nonmarketable bonds into market bonds. Nonmarketable bonds can be gradually converted to long-term maturity bonds. Such large volumes combined with long maturities and market interest rate can create a liquid bond market. Therefore, new issuances should reopen for existing long-term bonds.

[5] 3.3 percent.

12. To speed up the development of a developing domestic debt market, San Marino should enhance predictability and transparency. This can be achieved by (i) developing and publishing a medium-term debt strategy; (ii) publishing an annual borrowing plan, an issuance calendar and most importantly adhering to it; (iii) publishing a public debt report; (iv) keeping simplicity and standardization of instruments; (v) ensuring instruments are remunerated above the CBSM remuneration and have zero risk weight for domestic supervision purposes, and (vi) diversifying investors.

13. San Marino's debt transparency can be upgraded, building on current work. Currently, government issuances are published on the ministry of finance website. Improving the presentation, adding overall indicators of debt, and providing more frequent updates can be achieved with small efforts. Furthermore, the "Economic Program of San Marino" report includes extensive information on public debt. That information can be the starting point for an Annual Debt Report that can have more visibility. Initially, efforts should focus on areas that can pay-off quickly and with minimum resources, while the debt office develops.

14. It is key to continue strengthening the debt office capacity. The staffing of the debt office in 2022 is a step forward, and the priority ahead should be to ensure continuous training and enhanced risk analysis. With the limited staff, it is key to keep risk monitoring simple. Overall, there is a need for a professional and simple framework.

15. In addition, in the near term, a debt management operation to ensure the smooth rollover of Eurobond is a priority. This operation can be costly but waiting for better market conditions can be highly uncertain and more expensive. Countries that have faced similar rollover risks followed two approaches. A first approach is an early issuance of the new Eurobond (e.g., Albania (2017), Montenegro (2018)). A second approach is to secure funding from international financial institutions (IFI) and domestic markets in advance. Therefore, building up government deposits is critical.

Simulations of Debt Management Strategy

16. The main strategies will differ based on the degree of reliance on international markets and development of the domestic market. Using the IMF-World Bank template on medium term debt strategies (Balibek and others (2019)), four strategies are simulated.

Table VI.3. Debt Management Strategies

	Strategy 1	Strategy 2	Strategy 3	Strategy 4
External				
Eurobond Volume (€ million)	340	500	250	340
Eurobond Interest	5.75%	5.00%	5.75%	5.75%
Domestic				
1-year bond				
Share in domestic issuance	40%	40%	40%	0
Interest rate	1%	1%	1%	1%
5-year bond				
Share in domestic issuance	60%	60%	60%	100%
Interest rate	3.75%	3.75%	3.75%	3.75%

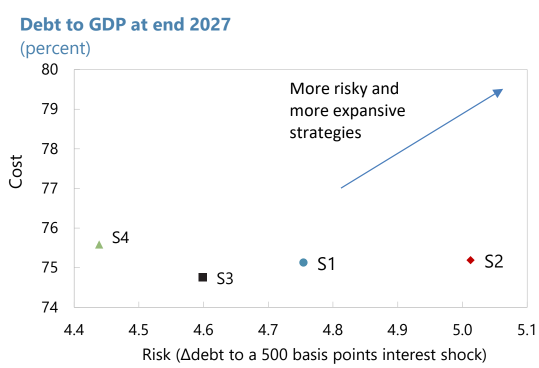
a) **Strategy 1 (S1)** considers issuances based on a combined approach of rolling over of the existing Eurobond (with a new Eurobond for €340 million at 5.75 percent interest) and issuing domestically to cover the rest of the gross financing needs. The domestic funding is distributed among 1-year and 5-year bonds with shares of 40 and 60 percent respectively.

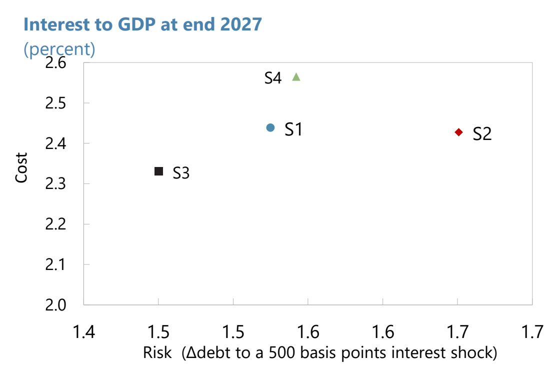
b) **Strategy 2 (S2)** replicates 1, but assumes the new Eurobond is issued for €500 million at 5 percent interest. The lower interest rate is assumed as the higher volume issued can allow to reduce interest rates by about 70 basis points (See Hardy 2022).

c) **Strategy 3 (S3)** replicates 1, but assumes the new Eurobond is issued for €250 million.

d) **Strategy 4 (S4)** replicates 1 but it assumes that all the domestic funding is at 5-year maturity.

17. The simulations highlight that the strategies have similar funding costs, but higher reliance on external funding imply greater risks. To approximate the trade-offs, the ratios of debt and interest payments to GDP are scattered with the changes in those indicators under an adverse shock. The adverse scenario is simulated with a 500-basis points shock to interest rate on international borrowing and 400 basis points shock in domestic borrowing. The results highlight that domestic funding seems less vulnerable to shocks in this environment.





References

Balibek E., Haque, T., Rivetti, D., and Tamene, M., 2019. "Medium-Term Debt Management Strategy: Analytical Tool Manual," IMF and World Bank Technical Notes and Manuals 2019/002, International Monetary Fund.

Briguglio, L. (2009) Small States: Debt Issues and Forward Strategy. Prepared for the Symposium " Small States: Weathering the Global Crisis". Washington DC: The World Bank.

Hardy, D., 2022. "Sovereign Eurobond Liquidity and Yields," IMF Working Papers 2022/098, International Monetary Fund.

International Monetary Fund (2014), "Revised Guideline for Public Debt Management"

International Monetary Fund and World Bank (2019) "Developing a Medium-Term Debt Management Strategy (MTDS)—Guidance Note for Country Authorities."

International Monetary Fund and World Bank (2021) "Guidance Note For Developing Government Local Currency Bond Markets" Analytical Notes No. 2021/001.

Nicholls, G. P. (2014). "Chapter 3. Public Debt Profile and Public Debt Management in the Caribbean". In Caribbean Renewal. USA: International Monetary Fund. Retrieved Aug 15, 2022.

Prasad, Abha & Pollock, Malvina & Li, Ying, 2013. "Small states -- performance in public debt management," Policy Research Working Paper Series 6356, The World Bank.

van der Wansem, P., Jessen ,L., and Rivetti, D., (2019) "Issuing International Bonds: A Guidance Note". MTI Discussion Paper, no. 13 Washington, D.C, World Bank.