San Marino—2012 Article IV Consultation

Concluding Statement of the Mission

San Marino, March 2, 2012

The economy has still not recovered from a long recession. Growing uncertainty about the external environment and the future role of the Sammarinese financial sector underscore the potential for a protracted recession and increasing vulnerability of the financial system. Continued compression of Sammarinese banks' balance sheets and profits are weighing on the fiscal position. Discussions with the authorities focused on alleviating financial system strain, including by building up capital buffers, and on measures to contain the fiscal deficit and enhance the economy's flexibility. There was broad agreement with the authorities that building a sustainable business model that is consistent with the new regulatory regime and does not rely on bank secrecy and tax-haven status is a fundamental long-term challenge. Moreover, normalizing economic and financial relations with Italy will be vital to facilitate a successful repositioning of the economy.

Economic Outlook

1. **The economic recession continues, while uncertainty looms large.** After four years of GDP contraction, primarily driven by external factors and largely manifested in a sharp fall in investment and manufacturing activity, the economy remains weak, with rising unemployment and construction activity well below its pre-crisis levels. Higher unemployment, stagnant wage growth, and lower confidence have all contributed to a fall in consumption. Meanwhile, the manufacturing sector, which is tightly integrated with Italy's production chains, faces weak demand prospects. While there are signs of an incipient recovery in tourism and commercial sector employment, we expect that real GDP will decline by about 2 percent this year and grow very modestly next year.

2. **Risks to the outlook are mainly on the downside.** San Marino is facing serious economic and financial headwinds, not least because of the permanent shock to output from the loss of the tax-haven business. Key downside risks to our baseline outlook include a deeper than expected recession in Italy, which accounts for 90 percent of Sammarinese exports, and rising strain in the financial sector. Normalizing relations with Italy could provide a boost to confidence. In particular, the ratification of the double taxation treaty with Italy, which is a precondition for the implementation of key economic and financial cooperation agreements between the two countries, could promote cross-border activity.

Financial Sector

3. **The financial sector is vulnerable, due to marked declines in liquidity, asset quality and profitability.** The banking system was able to withstand a 32 percent deposit outflow during the 2009-10 Italian tax amnesty, largely because of the previous substantial

holdings of, mainly foreign, liquid assets. Since then, banks' balance sheets have continued to decline on the back of steady deposit outflows (19 percent), contributing to the deterioration of liquidity, with the ratio of liquid assets to short-term liabilities falling to 55 percent, or half its pre-crisis level. As a consequence of the prolonged recession, nonperforming loans (NPLs) doubled over the past year to an estimated 10 percent of total loans, and are expected to continue to rise in the coming months. Meanwhile, bank profits have turned into losses, putting pressure on capital buffers.

4. **The recapitalization of Cassa di Risparmio di San Marino (CRSM) is a key priority, which requires a balance sheet restructuring and a sustainable business model**. CRSM has made substantial losses in the past two years, largely as a result of its decade-long involvement with the Italian Delta group. The losses from the resolution of Delta's collapse will leave San Marino's largest bank needing more capital and having a balance sheet dominated by Delta-related assets. The central bank is rightly insisting that CRSM should raise new capital. The government is contemplating participating in a proposed recapitalization, which also involves new capital from shareholders and customers, and which will total €150 million. The government should make participation strictly conditional on the shareholders meeting their commitment to add new capital and on the bank adopting a sustainable and strong business plan. Given its systemic risks, the bank should develop a contingency plan for future losses that may arise from a deteriorating external environment. Moreover, we question whether subordinated debt, even with the risks fully disclosed, is a suitable investment for ordinary retail customers of a bank. The central bank will need to ensure that CRSM complies with prudential norms, particularly on minimum capital and concentration risks.

5. **The authorities continue to make progress on meeting the FSAP recommendations as well as on broader transparency initiatives.** Further measures have been taken to strengthen the independence of the central bank (CBSM) and lower barriers to international regulatory cooperation. CBSM has fortified on-site and off-site supervisory functions, introduced a deposit insurance scheme, and new regulations allow it to assist in the provision of liquidity to banks. New regulations and international pressure have resulted in closures or mergers of some of the weaker banks and half of the fiduciary companies. The authorities are committed to adopting the European Union Directives on bank supervision as a condition of their prospective monetary agreement with the EU. The 2010 MONEYVAL report on AML/CFT measures and the 2011 OECD supplementary report on transparency in tax legal and regulatory matters both noted improvements made to laws and regulations and included recommendations for further strengthening, especially in respect of implementation of new requirements. Early action should be taken to address these recommendations. Moreover, remaining FSAP recommendations, particularly on supervisory and FIA resources, and inter agency cooperation should be further considered. Creating a track record of effective implementation of new measures and international cooperation is important to further rebuilding of confidence.

6. **The financial sector should adapt to the new domestic and international environment in which it operates.** The authorities fully understand that San Marino cannot return to the old business model which resulted in a rapid expansion of the financial sector, relying on the former regime of bank secrecy and weak regulation. In practice, international pressure and tougher new domestic regulation have already reduced the size of the banking sector balance sheets by more than a third and the assets managed by the non-bank fiduciary companies by over 75 percent. The recent introduction of new regulations and the prospective normalization of relations with Italy are necessary conditions for the return to international business by the financial sector, but they are not sufficient. Some in the private sector are looking creatively for niche products to sell on the international market, but most are seeking to provide traditional banking services to San Marino and the surrounding area. Both ambitions are reasonable, though San Marino and the surrounding area may not be big enough to support the regional aspirations of all the existing Sammarinese banks seeking to exploit it. Little practical action has been taken by the financial sector to identify an international competitive advantage, which would help them avoid further decline. While decline would reduce the risks, it would also reduce job opportunities and tax revenues. Hence, action is necessary both to identify the competitive advantage, if it exists, and to prepare for a smaller financial sector, if it does not.

Fiscal Policy

7. **The fiscal position has weakened, mainly due to a sizable decline in revenues.** Tax receipts, in real terms, are estimated to have fallen by 33 percent over the past four years, largely due to the recession and lower revenues from the financial sector. Over the same period, expenditure fell by about 17 percent in real terms. Consequently, the central government deficit has widened from zero in 2008 to an estimated 2.2 percent of GDP in 2010 and 3.3 percent of GDP in 2011. The three-year rolling budget law, recently approved by parliament, envisages a deficit of 2.4 percent of GDP in 2012. We are less optimistic, and project a deficit of close to 3½ percent of GDP this year, primarily on account of lower revenue projections. Financing the fiscal deficit is becoming increasingly challenging, as available resources are limited.

8. **The government recognizes the need to consolidate public finances.** In its latest budget, the government extended the temporary surtax on net income tax paid in the previous year, introduced a special tax on property, and imposed a minimum corporate income tax, applied also to the self-employed. Together, these measures are expected to yield additional revenues of about 1 percent of GDP this year. Expenditure is projected to remain constant in real terms in 2012, although expected to rise slightly as a percent of GDP, while the public sector wage bill will be contained by a freeze on nominal wages (in place since 2011).

9. **A comprehensive medium-term consolidation strategy is needed.** Given that revenues are likely to be permanently depressed by the financial sector downsizing, contingent liabilities from the financial sector are potentially very high, and the government

lacks access to a diversified investor base, we urge the authorities to embark on more comprehensive durable reforms to secure an effective medium-term consolidation strategy. On current policies, we project that government debt will continue to rise, from 18 percent of GDP today to 30 percent of GDP by 2017. Given this trajectory and the lack of sustained access to deficit financing, we call for permanent consolidation measures of 2½ percent of GDP, starting in 2013, which would result in government debt stabilizing at around 20 percent of GDP over the medium term. In particular, we recommend reducing income tax exemptions and deductions and broadening the application of indirect taxes. For example, the authorities should aim to increase the effective tax rate on personal income, currently at a low of 6½ percent (or about one third the average EU level). Moreover, expanding the tax base could include the replacement of the import tax (*monofase*) with a broader indirect tax, such as a value-added or consumption sales tax.

10. **The authorities have pursued public finance reforms.** The parliament has enacted a number of laws aimed at addressing the large and bureaucratic structure of the public administration and curbing its wage bill, but implementation is still pending. Pension reforms were introduced in recent years, including a second pillar (defined contribution) system in 2011, helping to improve the long-term sustainability of the pension system. The government also plans to introduce a broader tax reform in 2013, aimed at improving the equity and efficiency of the tax system. The current system is rather complex for a small country the size of San Marino, and the tax reform should provide a welcome simplification by unifying tax rates and eliminating some exemptions and deductions. Finally, we note that the public utilities company has been increasingly active in the Italian energy exchange. These activities do not appear directly related to managing energy supply in San Marino and hence should be closely monitored so as to minimize the risks to public finances.

Structural reforms

11. **Recent efforts to reduce rigidities in product and labor markets are welcome, but further reforms are needed to enhance the economy's flexibility.** The government has taken steps toward liberalizing and streamlining product markets, but some bureaucratic processes are cumbersome and barriers to entry in certain non-tradable sectors remain, undermining the economy's flexibility and competitiveness. Similarly, while recent steps have been taken to reduce labor market distortions, obstacles in hiring highly skilled nonresident workers linger. In addition, regulations related to cutting redundancy and the role the public sector plays as a major employer hinder market-driven private sector employment.

12. **Developing a basis for sustainable growth is a long term challenge.** As a result of the significant contraction of the financial sector and sharply reduced manufacturing base, we estimate that San Marino's potential GDP has declined by close to 20 percent in recent years. The continuing reduction in the size of the financial sector (if no competitive advantage is found and exploited) may further undermine San Marino's growth potential. Meanwhile, the future of the manufacturing sector is uncertain, given weak demand prospects from Italy in

the short term and rising competition from countries with lower labor costs in the long term. Hence, it is imperative that the government and the private sector explore avenues for sustainable growth. This may involve promoting the tourism sector, through initiatives that attract a greater number of visitors and lengthen average stay, and selective economic activities where San Marino has a clear advantage.

Statistical System

13. **The availability of macroeconomic statistics is limited.** Notwithstanding important progress on compilation and dissemination of monetary and financial sector data, national account statistics and fiscal data do not have the detail required by best practice international standards and are only available with a considerable lag. Moreover, the lack of balance of payments data, normally compiled by central banks, hampers a fuller analysis of macroeconomic linkages. In addition, the authorities do not prepare standard macroeconomic projections. The availability of reliable statistics on current economic conditions and up-to-date transparent government accounts is vital to designing appropriate economic policies and preparing realistic budgets, and will support San Marino’s increased engagement with the international business and financial community. San Marino’s ability to absorb technical assistance on this is inhibited by insufficient staff resources. We therefore urge the authorities to devote additional resources to meet international standards for national accounts and government finance statistics.

We would like to thank the authorities and other interlocutors for the productive discussions and their warm hospitality.