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INFORMATION

June 8, 1994

To: Members of the Executive Board

From: The Secretary

Subject: San Marino - Staff Report for the 1994 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1994 Article IV consultation with San Marino, which is tentatively scheduled for discussion on Friday, July 15, 1994.

Mr. Lane (ext. 37668) or Mr. Hamann (ext. 34154) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

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INTERNATIONAL MONETARY FUND

SAN MARINO

Staff Report for the 1994 Article IV Consultation

Prepared by the Staff Representatives for the 1994 Consultation with San Marino

Approved by Michael Deppler and Mark Allen

June 6, 1994

I. Introduction

A staff team 1/ visited San Marino during April 6 to 15, 1994 to conduct the 1994 Article IV Consultation discussions. The mission met the Secretary of State for Finance and Budget, the Secretary of State for Foreign Affairs, the Ministers of Industry and Handicrafts, Labor, and Commerce, the Director of the Sammarinese Credit Institute (the recently-established central bank), the Directors of the Social Security Institute and the Office of Bank Supervision, and other government officials, as well as representatives of manufacturing and other economic sectors, commercial banks, and trade unions. There was also an audience with the Captains Regent, the joint heads of state. Mr. Lanciotti, the Executive Director for San Marino, held discussions with the authorities prior to the mission. San Marino has accepted the obligations of Article VIII, Sections 2, 3, and 4.

These were San Marino's first Article IV Consultation discussions since accession to membership in the Fund in September 1992. Since then, there have been two short staff visits, in December 1992 and December 1993.

In the most recent elections for the Great and General Council (the Sammarinese parliament), held in June 1993, the ruling coalition of Christian Democratic and Socialist parties returned to power. Under this government, San Marino continued its policy of widening its international involvement. Previous steps along this path included membership in 1992 in the Fund, the United Nations, and the Council for Security and Cooperation in Europe; the Cooperation Agreement with the European Union (1991); and the Exchange and Financial Agreement with Italy (signed in 1991 and now moving towards implementation).

San Marino maintains a system free of restrictions on the making of payments and transfers for current international transactions.

1/ T. Lane (head), A. Hamann, A. Prati (all EU1), T. Mathisse (STA), with G. Jeffers (EU1) as staff assistant.

II. Background to the Discussions

Economic conditions in San Marino are shaped by the country's particular circumstances, as a tiny mountain enclave in north-central Italy, covering an area of 62 square kilometers, with a population of some 24,000. Geography, together with the absence of border controls with Italy and the use of the Italian lira as the domestic currency, have helped integrate San Marino into the economy of the surrounding regions of Emilia-Romagna and Marche. At the same time, San Marino has maintained a distinct set of political and economic institutions.

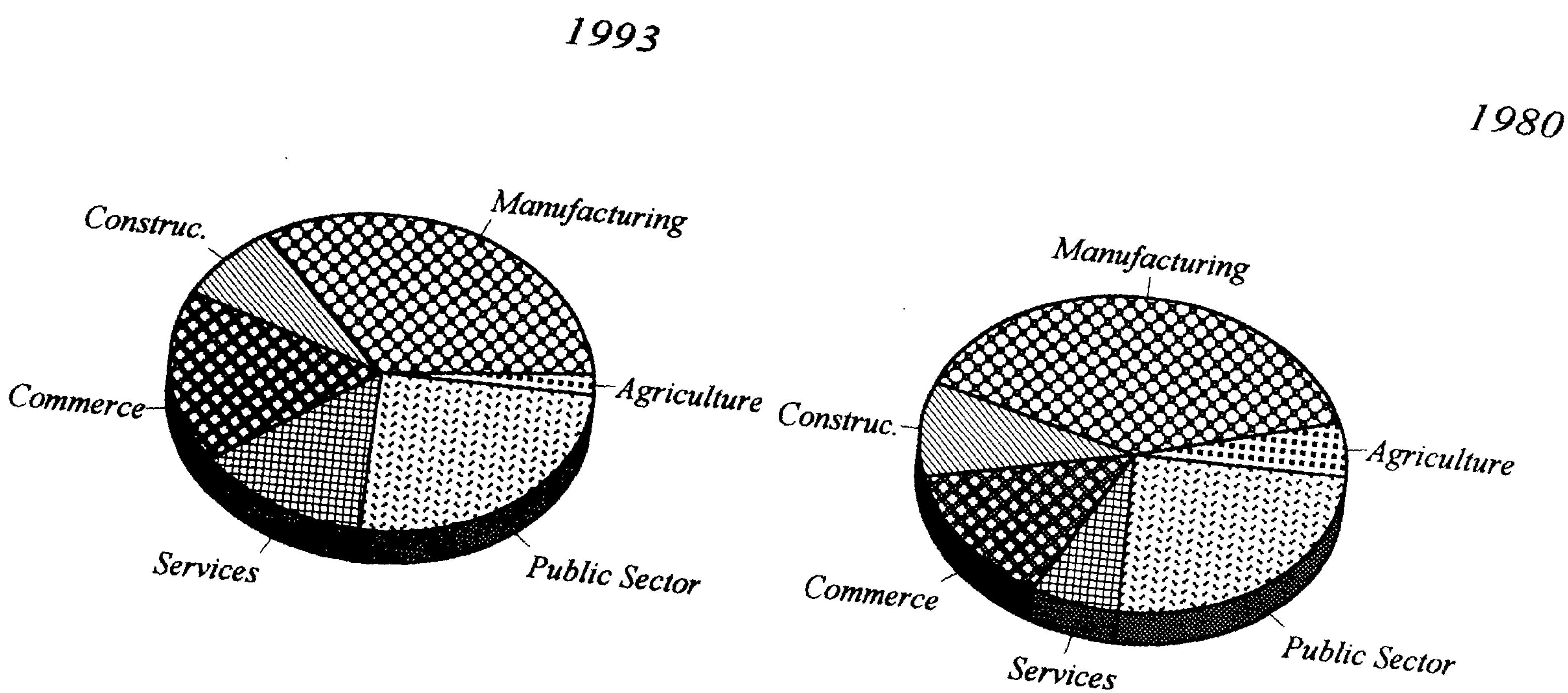
Several sectors of the Sammarinese economy have been important in its development; their shares of total employment are shown in Chart 1. There is a diversified industrial sector consisting of a large number of firms, which average fewer than 10 employees per firm. The country receives some 3 million visitors annually, but these consist mainly of tourists staying at the popular Adriatic beaches who come to San Marino for a few hours, and thus do not generate a commensurate tourist service industry. There is, however, a substantial volume of commercial activity oriented towards these day visitors, also benefiting from lower tax rates than in Italy. The banking system is relatively large, with total liabilities in 1993 estimated at nearly 800 percent of GDP; it attracts substantial nonresident deposits due to lower rates of withholding tax and greater bank secrecy than in Italy. The public sector plays an important role in the Sammarinese economy, and accounts for one-quarter of total employment. Agriculture, once a key area of economic activity, is now of negligible importance except as a means of preserving the environment.

The Sammarinese economy appears to have weathered the European recession rather well so far. Some industries, such as textiles and tourism, were affected adversely by the recession, but others, such as ceramics and banking, experienced favorable conditions. No measures of aggregate economic activity are available, but labor market data suggest continued, although likely decelerating, growth. 1/ Unemployment remained relatively low at 4.9 percent in December 1993 compared with 7.4 percent in Emilia-Romagna and 11.3 percent in Italy as a whole. This marked only a small rise in relation to 1992, and was still below the 1988-92 average (see Chart 2). Total employment continued to grow as labor was drawn into San Marino from Italy and elsewhere; by 1993, nonresident workers (*frontalieri*) accounted for roughly one-quarter of private sector employment. 2/

1/ In particular, San Marino's national accounts are only experimental and the most recent data available are for 1992, when they show an estimated growth rate of GDP of 9.6 percent. No data are collected on industrial production, retail sales, or other indicators of aggregate economic activity.

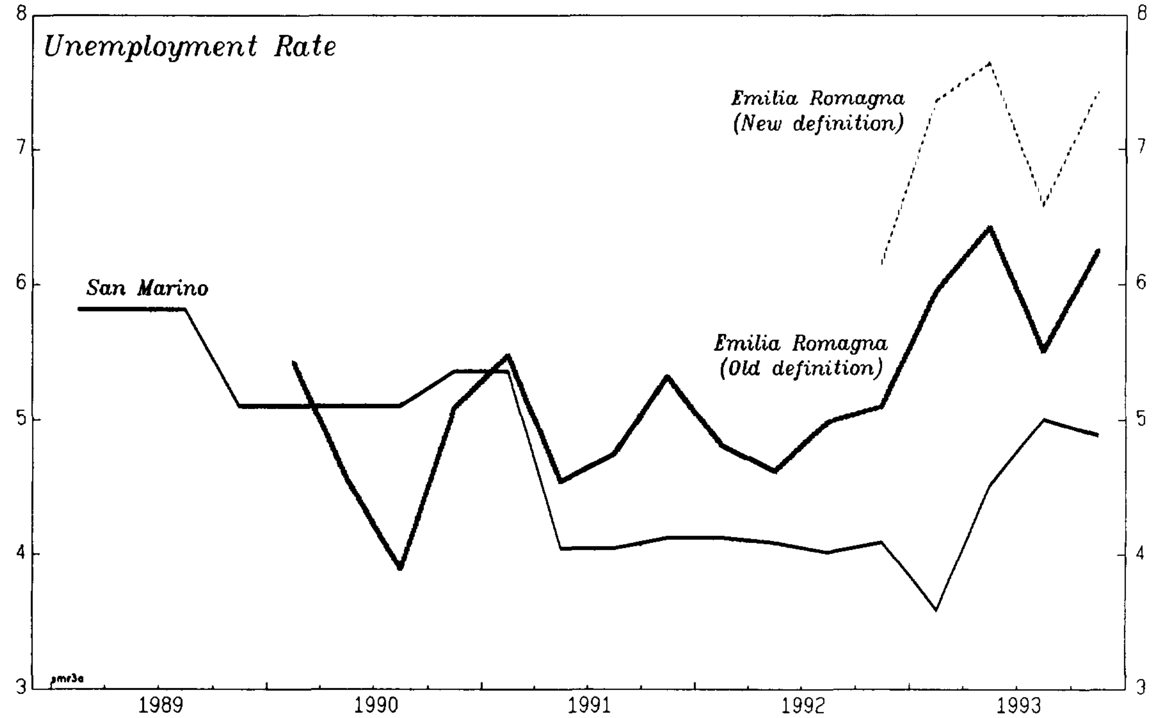
2/ In calculating the unemployment rate, non-resident workers are excluded from the denominator.

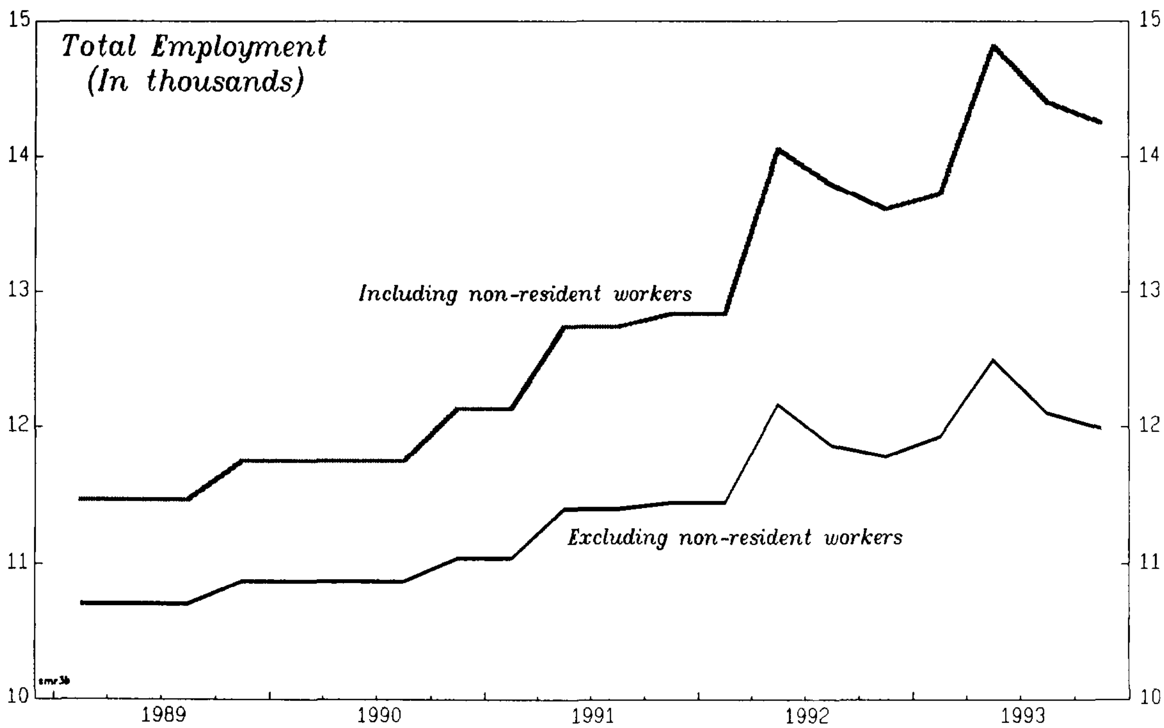
Chart 1
San Marino
Employment by Sector
(In Percent of Total Employment)



Source: Sammarinese Authorities.

CHART 2
SAN MARINO
Unemployment Rate and Total Employment





Sources: Sammarinese Authorities; and Italian authorities.

There are several reasons for San Marino's favorable recent macroeconomic performance. The many tiny firms in the industrial sector proved adaptable in the face of problems experienced by particular industries. Economic activity and employment were supported by activist policies, including the expanded use of preferential credit and selective exemptions from social security contributions, import tax, and corporate income taxation. In contrast to other European countries, a generally strong fiscal situation, with no net public debt, gave the Sammarinese Government room to introduce such measures. 1/ The banking system benefitted as Italian investors moved deposits to San Marino in the face of uncertainties about taxation and the political situation in Italy.

Moreover, San Marino gained some competitiveness from the real depreciation of the lira, which stimulated exports, counterbalancing the decline in domestic demand in Italy. Although countries other than Italy account for only an estimated 10 percent of Sammarinese exports, total exports were estimated at 260 percent of Sammarinese GDP in 1992. Exports amounting to roughly a quarter of GDP would therefore have been affected by the external depreciation of the lira, although the domestic value-added component of these exports is unknown. The depreciation may therefore have played a significant role in sustaining economic activity in San Marino, as in the surrounding areas of Italy.

Chart 3 depicts the real exchange rate of the Italian lira vis-à-vis the non-lira zone. 2/ This is only a partial measure of San Marino's competitiveness, as Sammarinese inflation may also have differed from Italy's. However, differences in San Marino's reported consumer price index from Italy's are attributable mainly to differences in the basket of goods used, and only incidentally to differences in prices of similar items in the two countries; the ratio of consumer price indices would therefore be of little use as a major component of a measure of competitiveness. 3/ There are no data on labor productivity, so a real exchange rate based on relative unit labor costs also cannot be calculated.

The currency union ties monetary developments in San Marino to those in Italy. In particular, interest rates followed a downward course along with those in Italy during 1993 and early 1994. For example, average rates on

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1/ There is also a Full Employment Law guaranteeing public sector employment to those who are certified unemployable, especially the handicapped.

2/ Italian trade weights are used. Data on Sammarinese trade are of such doubtful quality that they should not be used to construct a separate real exchange rate series.

3/ San Marino's consumer price index does not reflect differences in consumption patterns between San Marino and Italy, as it is based on the 1985 Italian basket of goods, whereas in Italy the basket has been changed twice since 1985. Beginning in 1994, San Marino will use the current Italian CPI basket.

repurchase agreements offered by Sammarinese banks declined from an average of 13 percent in 1992 to 7.3 percent in the first quarter of 1994 (Chart 4). The continuing uncertainties of the political and tax situation in Italy led to a rapid growth of deposits and repurchase agreements, notably the nonresident component which is conservatively estimated at 55 percent of the total. Total liabilities of the banking system (consisting mainly of deposits and repurchase agreements with residents and nonresidents) grew by 22 percent during 1993, following 47 percent growth in 1992. At the same time, domestic credit (as measured by total claims on domestic nonbank nongovernment sectors) grew much more modestly, by about 7 percent, a deceleration from growth of 36 percent in 1992, albeit still an expansion in real terms. 1/ The share of domestic credit in total bank assets declined further, to only 13 percent in 1993 from 15 percent in 1992. As has been typical, banks used most of the funds received through deposits and repurchase agreements to increase their own holdings of deposits, repurchase agreements, and securities issued by the Italian banks and Treasury. The slowdown in lending may be partly attributable to the rising share of repurchase agreements in bank liabilities, perceived as a more transient source of funding; it may also reflect some increase in the perceived riskiness of lending. The Sammarinese banks have experienced some increase in problem loans, but their level remained low in relation to that in Italy. The Office of Bank Supervision reported that the four commercial banks' capital adequacy ratios were in the 15 to 20 percent range, in comparison with the 8 percent minimum required in the EU.

An important development affecting the Sammarinese banking system concerns the Exchange and Financial Agreement with Italy, signed in 1991 but still not implemented. This agreement would give the Sammarinese banking system direct access to foreign and international markets, whereas at present all transactions are required to go through Italian correspondents. A ministerial exchange of letters set in motion a procedure for implementating the agreement, effective April 1, 1994. According to this procedure, a joint committee will be set up, and over the next few months will determine the conditions under which the agreement will be implemented. A key issue for this committee to resolve is fiscal monitoring, given the obvious importance of San Marino as a nonresident banking center. At this time, it is not clear whether arrangements would entail first- or second-degree monitoring, distinguished on the basis of whether the Sammarinese authorities would have to report to the Italian tax authorities with regard to money deposited by Italian residents in San Marino or whether this information would be provided only if the deposits were subsequently transferred to a third country. The arrangements on fiscal monitoring and other regulatory issues represent an important uncertainty for the Sammarinese banking system, given its dependence on nonresident business.

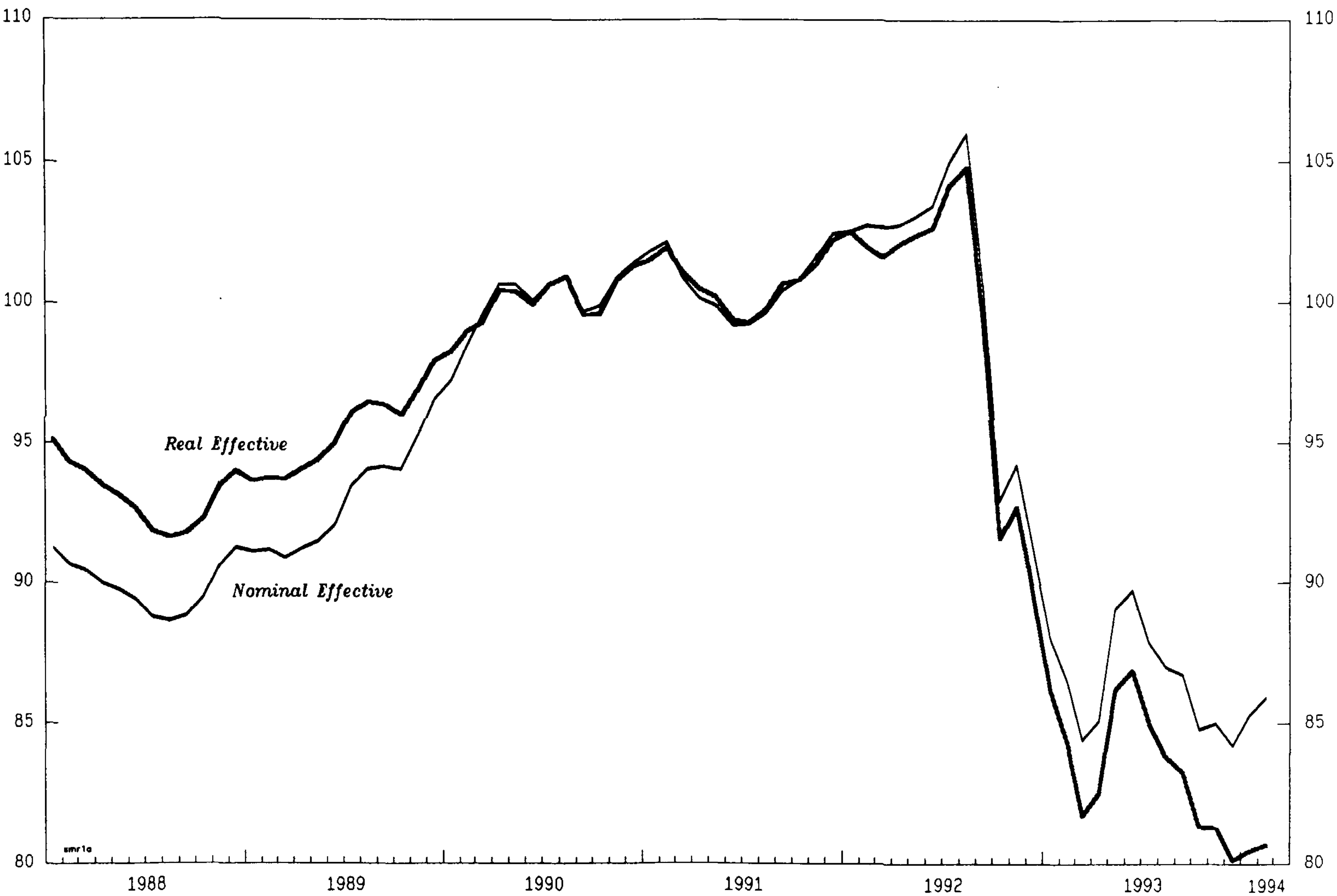
1/ This expansion in credit includes preferential credits. The regime for assigning preferential credit is discussed in detail in the background paper.

CHART 3

ITALY

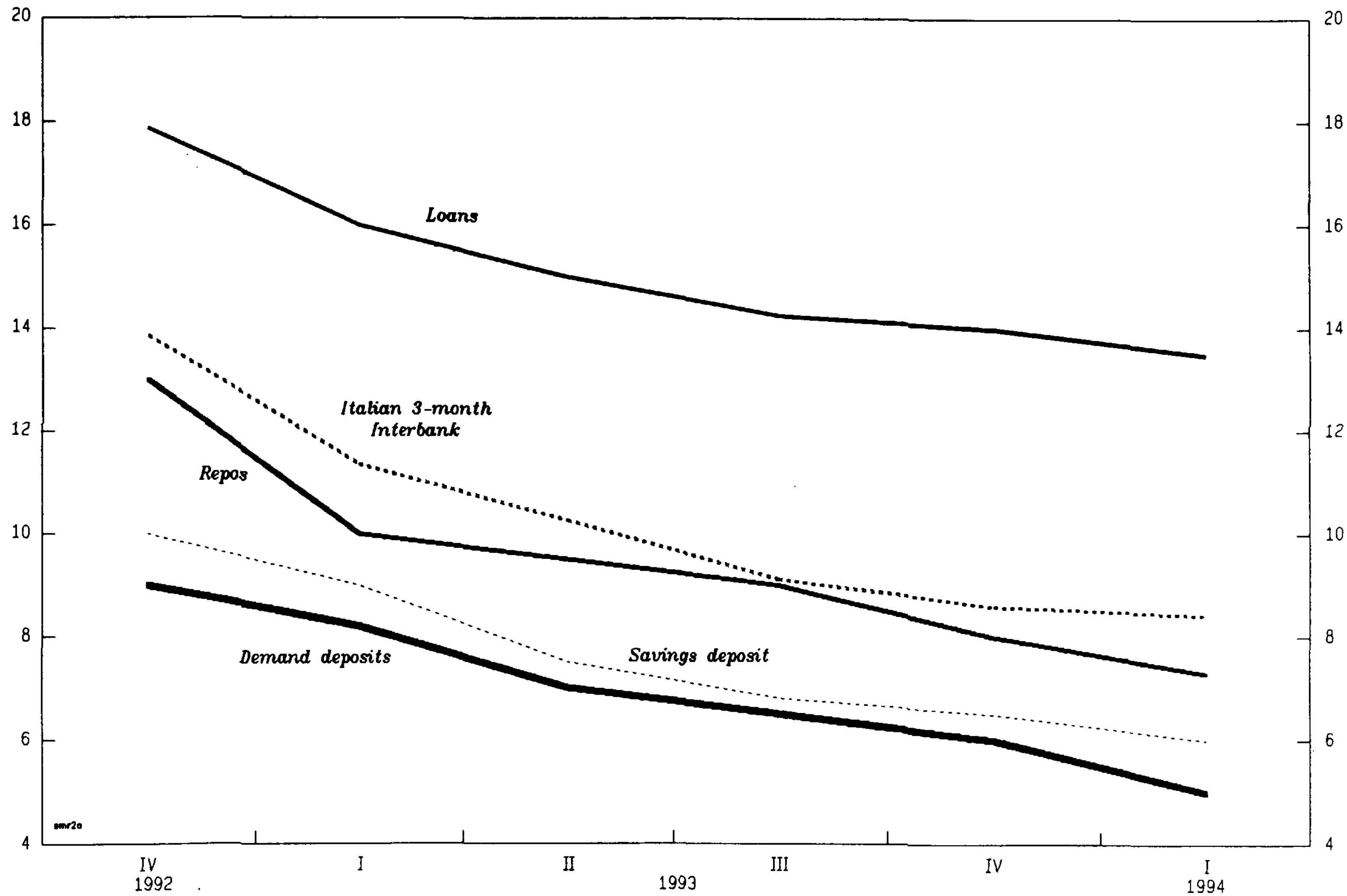
Effective Exchange Rate of Lira

(1985=100)



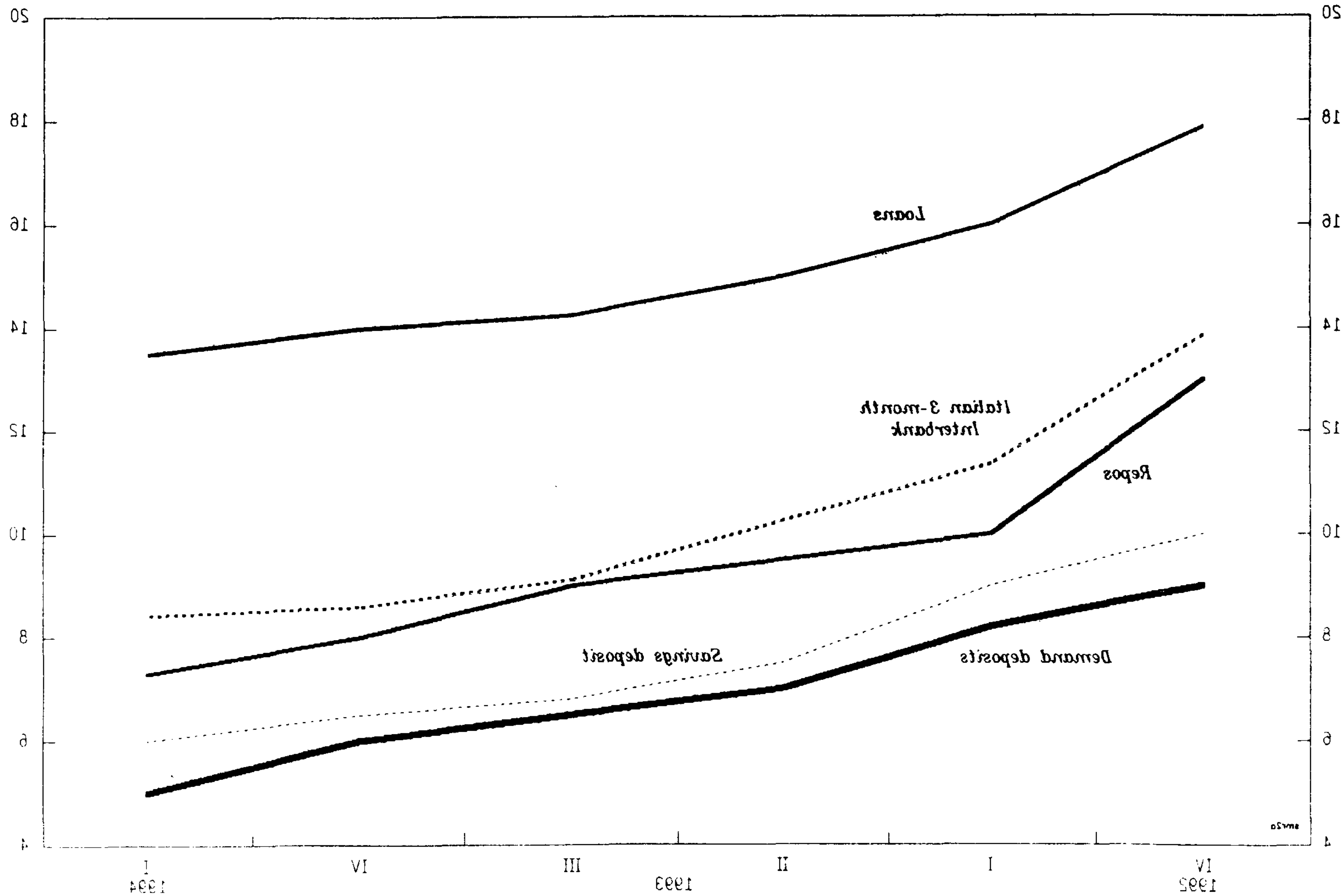
Source: IMF, International Financial Statistics.

CHART 4
SAN MARINO
Selected Interest Rates



Sources: Sammarinese Authorities; and Bank of Italy.

CHART 4
SAN MARINO
Selected Interest Rates



Sources: Sammarinese Authorities; and Bank of Italy.

Another aspect of the institutional framework of the monetary sector is the Sammarinese Credit Institute (ICS), an embryonic central bank established in 1991. When established, the ICS was given an ambitious mandate: to promote the development of the economy; to oversee the smooth functioning of the banking system; to encourage growth of trade; and to promote the balanced expansion of the banking and financial system. However, the currency union with Italy deprives it of most of the typical functions of a central bank. It has no instruments with which to influence domestic money, credit, and interest rates, and also no influence over domestic inflation. Moreover, it shares responsibility for the financial system with the Office of Bank Supervision (*Ispettorato per il Credito e le Valute*), founded in 1984, which supervises, regulates, and gathers data on banks and other financial institutions. The ICS is therefore unlikely to be assigned any important regulatory function. Its tiny staff of about a dozen people, most with no prior banking experience, also limits its ability to fulfil a broad mandate. At this point, its main task is as the state treasury agent. The deposits of the central administration, amounting to some Lit 257 billion (about 31 percent of Sammarinese GDP), were transferred to the ICS from the Sammarinese commercial banks by the end of 1993, and managing these deposits is now its exclusive responsibility. 1/ The Exchange and Financial Agreement, when implemented, will give the ICS another role as the foreign exchange bank of the Sammarinese banking system; the ICS will be authorized to deal in foreign exchange on the same basis as Italian foreign exchange banks. 2/

San Marino enjoyed an enviable series of fiscal surpluses in recent years, averaging over 2 percent of GDP during the 1989-1992 period (Chart 5). This was attributable in part to the rapid growth of revenues, which more than kept pace with rising expenditures. In addition, fiscal management was conservative, leading to a pattern of budget overperformance.

More recently, there was a change in the fiscal situation. The key underlying factor was a sharp rise in public sector salaries that emerged from the last round of wage negotiations. In the central administration, average salaries rose by 20 percent in 1992 and another 6 percent in 1993. At the same time, employment rose by 7 percent in 1992, and another 4 percent in 1993. 3/ Together these changes raised the state payroll by some 40 percent in 1992 and 1993.

1/ Most of the deposits of other public sector entities (including the ISS) have also been transferred to the ICS, although these entities are also legally permitted to hold deposits elsewhere.

2/ It has yet to be decided whether the other Sammarinese banks will also be permitted to deal directly in foreign exchange.

3/ The latter figure for 1993 excludes the transfer of a group of maintenance and support staff from one of the public enterprises to the central administration. This involved almost 300 workers, over 12 percent of central administration employment. The transfer of these workers to the state payroll was accompanied by a reduction in budgetary transfers to the state enterprise where they had previously been employed to perform the same services.

Despite the fact that much of the increase in public sector payroll occurred in 1992, the effects on the fiscal balance on a cash basis did not appear until 1993, due to an unusually large increase in tax revenues in 1992 as well as an exceptionally favorable balance of settlements of outstanding float in tax payments and reimbursements. 1/ These extraordinary circumstances led to an improvement of San Marino's overall fiscal balance on a cash basis in 1992 to nearly 5 percent of GDP, despite the increased spending resulting from an enlarged public sector payroll. Then, in 1993, the estimated fiscal surplus weakened to less than 1 percent of GDP.

Social security, the responsibility of the Institute for Social Security (ISS), includes pensions, health, a wage supplementation fund for temporary layoffs (*cassa integrazione guadagni*), income support for workers laid off permanently (*indennità speciale*), family allowance, and other welfare programs. San Marino's pension system has been helped by the rapid growth of employment, averaging 5 percent annually over the past five years. This growth has been due both to favorable demographics and to extensive employment of nonresident workers, who by 1993 amounted to about one-quarter of the private sector labor force. 2/ Prior to 1991, the resulting surpluses in some pension funds were used to cross-subsidize deficits in other areas of social security, mainly health care, where costs were rising with both increased salaries and widening of the range of services covered. In 1991, a decision was made to segregate pensions from other aspects of social security; this meant that those pension funds that were in surplus--notably the fund for dependent workers--could accumulate assets.

The 1994 budget did not make any major changes in the taxation or in expenditure plans. The only available budget projections for 1994 were made in October 1993; these envisage a very modest expansion in revenues, and a slight decline in spending, compared with revised projections for 1993. They projected a very small nominal increase in direct tax revenues, implying a decline of some 4 percent in real terms, due mainly to a reduction in revenues from withholding tax on interest income as a result of the projected decline in interest rates. Indirect tax revenues are projected to rise by a little over 4 percent, implying little change in real terms. Revenues collected from the import tax, which applies to goods imported both from Italy and other countries, are projected to be constant in nominal (lira) terms, implying a real decline of some 4 percent. This pessimistic projection is motivated by concerns that changes in import taxation associated with some changes in regulations in the EU which may lead imports and associated revenues to fall. For instance, value added tax (VAT) on automobiles was previously collected in the country where the sale

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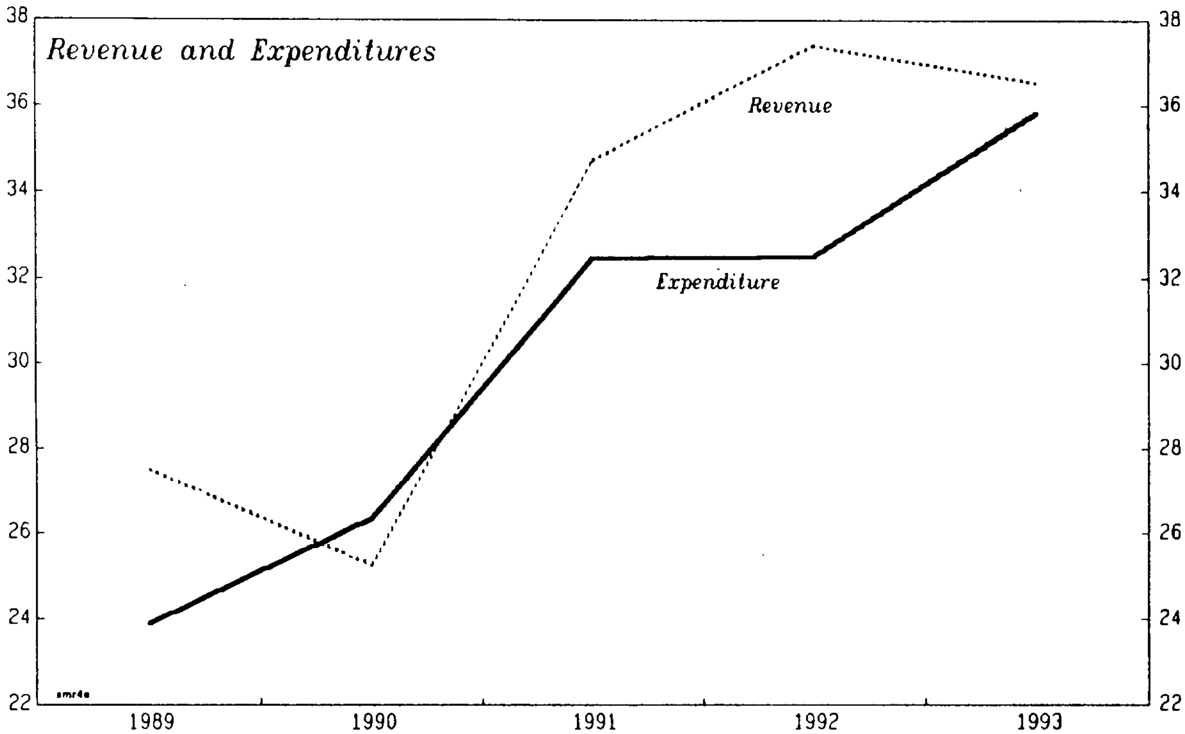
1/ Outstanding unsettled balances of tax on imports, and its reimbursement for re-exported goods, are of the same order of magnitude as annual revenues and expenditures.

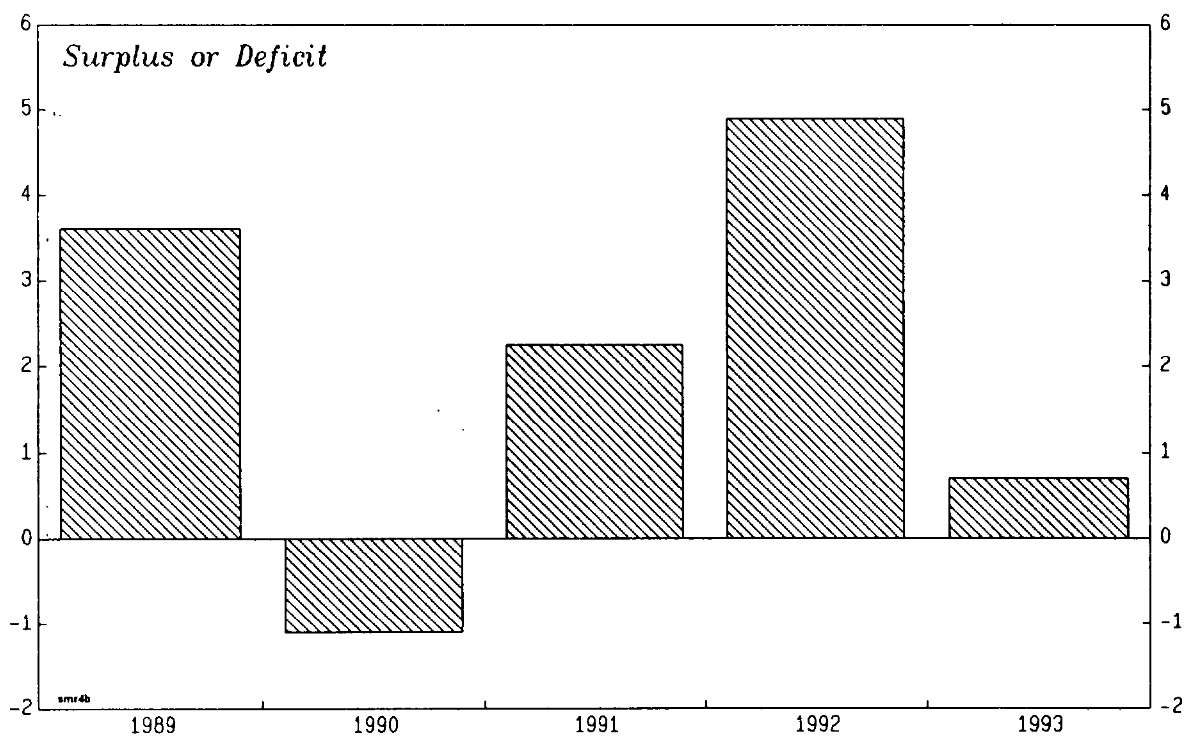
2/ Many of these nonresident workers will eventually be eligible for pension benefits, depending on their duration of employment.

CHART 5

SAN MARINO

Revenue, Expenditures and Surplus or Deficit
(In percent of GDP)





Sources: Sammarinese Authorities; and staff estimates.

took place, providing an incentive for Italian residents to purchase cars in San Marino. Since the beginning of 1993 it is collected by the country in which a car is registered, regardless of the country in which it was purchased. This is expected to depress auto sales by Sammarinese dealers, and therefore reduce revenues from the import tax.

Expenditure in several areas is projected to decline from 1993 levels, but this is attributed mainly to nonrecurring spending items in 1993, rather than to any deliberate policy adjustment. 1/

III. Policy Discussions

In presenting their policy agenda, the authorities emphasized their intention to increase San Marino's involvement in the world economy and its institutions. In this regard, they stressed the potential role of international surveillance, which they viewed as useful in providing external scrutiny for Sammarinese economic policies and institutions. They also welcomed advice on improving the quality of the statistical base.

The authorities recognized that this process of integration would require a greater degree of harmonization of taxation and regulations with neighboring countries. In particular, the Cooperation Agreement with the EU will require the introduction of a value added tax on domestic production at the same rate as the current single-stage import tax by 1996; and the Exchange and Financial Agreement with Italy will likely require some exchange of information relevant to the Italian authorities' investigation of possible tax evasion and money laundering. The authorities said they would have to achieve a compromise between their desire to participate more widely in the world economy and their desire to preserve Sammarinese sovereignty and institutions. The staff noted that while the transition would likely entail difficulties for some sectors, and might for some time lead to a significant decline in government revenues, harmonization could also have some potentially beneficial consequences for San Marino. In particular, it could reduce San Marino's vulnerability to wide swings in national income and government revenues, associated with changes in the political, tax, and regulatory situation in Italy--as illustrated by the variations in tax revenues associated with variations in nonresident deposits and nonresident automobile sales.

While San Marino's fiscal situation has, on the whole, been a major strength, there have lately been some signs of weakening, in which public sector wage increases have played a critical part. The staff discussed the issue of public sector salaries with government officials, representatives of industry and other sectors of the economy, and organized labor. There seemed to be quite general agreement, even by the trade unions, that these

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1/ The nonrecurring items include land purchases, the payout of money previously accumulated in a severance pay fund, and some subsidized loans.

salaries were inappropriately high relative to those in the private sector. Not only the fiscal, but also the structural aspects were emphasized: high salaries, accompanied by the shorter working hours and greater job security of public sector employment, had created an incentive for many Sammarinese workers to wait for a job in the public sector rather than accepting available private-sector openings. This labor market distortion may have ancillary fiscal consequences, as preferential credit and tax exemptions are given to provide employment to those who become unemployed as a result. The 1991-93 contract for public sector workers stipulated that new entrants earn 20 percent less than the standard salary for their first two years, but this was seen as insufficient to rectify the imbalance. A further adjustment could be incorporated in the 1994-96 public sector wage contract, to be concluded later this year.

The authorities discussed their projections for the pension plans, according to which the funds will collectively be solvent over the next five years. The ISS has begun to accumulate reserves for these funds to cover possible shortfalls in the future. The staff expressed concern that some potential problems, including those associated with a possible slowdown of labor force growth, might only surface over the longer term, with the retirement of the present cohort of workers. 1/

Another issue discussed was the remuneration of public sector deposits, which include the reserves accumulated by the pension funds. At the end of 1993, these deposits amounted to Lit 257 billion, an estimated 31 percent of GDP. Currently, these funds are deposited with the Sammarinese Credit Institute (ICS); the latter has, in turn, deposited over one-third of these funds in the Sammarinese commercial banks, where they are remunerated at a rate fixed at a spread of 2 percentage points below Italian interbank rates. The staff queried the reasons for such a wide spread, given the commercial banks' ease of on-lending the funds in the Italian interbank market. The authorities said that holding large deposits in the Sammarinese banking system at below-market rates would only be a transitional arrangement.

On the monetary side, one issue is the emerging role of the ICS as an embryonic central bank. The staff asked what remained for a central bank to do, given that most traditional central banking functions are not relevant in the context of the currency union. The authorities appeared to have few plans for how it might go beyond its current treasury management function.

A key structural area is the labor market. Here, in addition to the issue of public sector wages, the discussions focused on the continued

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1/ These issues are discussed further in the background document.

100 percent indexation of wages to Italian inflation. 1/ Until recently, this led to a gradual rise in Sammarinese wages relative to those in Italy, given the degree of indexation in Italy under the *scala mobile*. The authorities pointed out that when the lower social contributions in San Marino are taken into account, total hourly labor costs are no higher than in Italy, despite higher wage levels in San Marino. 2/ The staff pointed to the danger that, with the July 1992 agreement in Italy abolishing the *scala mobile*, continuing full indexation in San Marino could lead to a steady erosion of competitiveness. The trade union representatives mentioned that unlike in Italy, where indexation was established by law, in San Marino it was incorporated in labor contracts in each sector. Eliminating indexation would therefore require a change in the outcome of the next wage negotiation round, scheduled for later this year.

The discussions also covered the role of government intervention in the economy. The authorities pursue an activist industrial policy, using preferential credit and tax concessions. They see this interventionist approach as necessary to help the Sammarinese economy adapt to changing conditions. They argue that, in such a small country, government involvement is needed to ensure the existence of a mix of jobs that matches the skills of the work force. They often try to target assistance to productive activity that would provide employment to specific groups of unemployed workers. 3/ The staff noted, however, that a key element of flexibility in the Sammarinese economy is its many tiny private enterprises, and expressed concern that this flexibility might be impaired by excessive state involvement. The increased tax burden resulting from the cost of the assistance should also be taken into account, notwithstanding a still relatively low level of tax pressure. The staff also warned that such employment-promoting state aid could exacerbate existing labor market pressures, especially at a time when employment was already expanding, the unemployment rate was low, and there were many unfilled vacancies.

Discussion has begun in San Marino regarding the possibility of privatizing some public sector entities, although these discussions are at a very early stage. The authorities saw the use of privatization proceeds as an important issue, given the absence of public debt and the relatively low level of tax pressure. There seemed, however, to be widespread agreement

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1/ During the year, workers are awarded an increase equal to 70 percent of (Italian) inflation in the previous year. Then, at the end of the year, they are given the difference between this year's inflation and 70 percent of last year's, if this difference is positive. If actual inflation is less than 70 percent of the previous year's, the difference would in principle be clawed back, although the authorities were skeptical of whether this would occur in practice.

2/ No data on productivity are available.

3/ They cited the example of a group of female unskilled workers who were thrown out of work when their textile factory closed; assistance was provided to another company that undertook to employ the entire group.

that privatization proceeds should not be used to finance current spending. The trade unions, which support privatization of some activities, have suggested that the proceeds be used to finance public investment in infrastructure. Another alternative, suggested by the staff, would be to use these proceeds to supplement the reserves of the pension funds.

Another important task of the mission was to help improve the statistical base (see Appendix I). The authorities were particularly interested in the mission's advice on the appropriate presentation of data according to international standards. There are serious gaps in the coverage of statistical systems, as well as problems of classification, which continue to impair the quality of available economic data.

The staff also raised the issue of international development assistance. While recognizing that a small country can make only a limited contribution to international development, the staff said that all countries, particularly high-income countries such as San Marino, had a responsibility to contribute what they could. The authorities said they intended to increase San Marino's assistance to developing countries, viewing such assistance as a demonstration of international solidarity.

The staff also discussed with the authorities the timing of the next Article IV consultation. The authorities accepted the suggestion that this be carried out on the 24-month cycle.

IV. Staff Appraisal

On the whole, San Marino has made effective use of the opportunities presented by its situation. It has benefitted from its location, together with a common currency and the absence of border controls, to develop an industrial and commercial economy that has participated fully in the rapid economic growth of the surrounding regions of north-central Italy.

At the same time, San Marino has used small differences in its tax and regulatory structures from those of Italy to attract large volumes of business to its commercial and banking sectors. Such economic activity based on tax and regulatory arbitrage has been an important source of national income and government revenue. The recent move toward greater involvement with the EU may open fresh fields for such activity, but this is likely to be largely offset by the effects of the greater tax and regulatory harmonization that greater involvement with the EU will entail. Harmonization may itself have some benefits to the Sammarinese economy over the longer term, as it brings efficiency-enhancing competition, as well as reducing the risks associated with the existing dependence of San Marino's national income and public finances on volatile cross-border activity. However, the transition carries some risks that greater harmonization may adversely affect the commercial and financial sectors on which the public finances are particularly dependent for revenues.

In facing these risks, San Marino is starting from a position of some strength, particularly as regards its fiscal position. The typically conservative fiscal policy has been broadly appropriate for San Marino, given the unpredictability of revenues and expenditures. In this light, the recent weakening of the fiscal balance causes some concern. In addressing this situation, it will be particularly important to rectify the imbalance in public sector salaries, not only because of their direct fiscal impact but also to the extent that they give rise to a structural distortion in the labor market.

The public pension system is currently in a strong position, as the rapid growth of employment has ensured a favorable ratio of contributors to beneficiaries. The concern for the future, though, is that the ISS only takes account of projections of revenues and outlays for the next five years, and may be overlooking problems whose consequences would materialize later. If labor force growth were to slow--as is likely, given San Marino's limited physical resources--it is not clear whether contributions would continue to be adequate to finance pensions promised to the current cohort of workers. It is important that the authorities examine this issue and set levels of benefits and contributions that are sustainable over the long term, as well as accumulating an appropriate level of reserves to deal with possible adverse changes in demographic trends.

Monetary conditions in San Marino are mainly dictated by its currency union with Italy. This currency union is appropriate, given San Marino's small size and its integration into the Italian economy. Given the currency union, however, the role of the ICS as a central bank is still unclear, three years after its establishment. The authorities need to give more serious thought to the question of what purpose can be served by a central bank given the inherent limitations on its scope for action. Caution is also essential in any expansion of the role of the ICS, given the risks of entering uncharted waters. Meanwhile, the ICS has a vital responsibility for managing public sector assets, including the reserves of the pension funds, in such a way as to ensure an adequate return.

In the labor market, one key concern is the gap between public and private sector wages, which may create structural unemployment--and therefore also, given the authorities' concern with unemployment, create pressure for increased public sector hiring. A second is the continued 100 percent indexation of wages, which threatens a creeping erosion of competitiveness. It is important that both of these problems be addressed in the forthcoming wage negotiations.

Another structural issue is San Marino's program of state aid to industry, through preferential credit and tax concessions. The concern is that an increase in the scale of such aid could create distortions in the allocation of resources. Moreover, the aid is often targeted to particular groups of unemployed workers; given the potential moral hazard problems of such a case-by-case approach, it would be preferable to reduce unemployment by increasing the overall flexibility of the labor market through appropriate labor market reforms.

Privatization in San Marino is in its initial states, and holds the promise of reducing state intervention in the economy. To be consistent with this goal, any revenues from privatization should not be used to finance additional state involvement in productive activity or current government spending. Accumulation of assets for the pension system or, where warranted, investment in infrastructure (including education and training) would be more appropriate uses of privatization proceeds.

It is important that San Marino make an adequate contribution, on its own scale, to international development assistance.

It is recommended that the next Article IV consultation be carried out on the 24-month cycle.

Table 1. San Marino: Basic Data

Total area (sq. Km):	61.2
Population (December 1993):	24,335
GDP per capita (current US$, 1992):	24,957
Life expectancy (1987):	76 (male)
	82 (female)
Infant mortality (1989/1993 average):	9.7 per thousand

	1989	1990	1991	1992	1993
	(Changes in percent except as otherwise indicated)				
Domestic economy					
Real domestic demand (contribution to GDP growth)	2.2	6.1	6.7	7.4	...
Real foreign balance (contribution to GDP growth)	-0.5	--	0.4	2.2	...
Real GDP	1.8	6.2	7.2	9.6	2.4 1/
Unemployment rate (end of year)	5.1	5.4	4.1	4.1	4.9
Annual average inflation rate	6.3	6.4	6.3	5.1	5.5
External accounts					
Trade balance (in millions of US$)	-10.3	-12.3	-10.5	0.9	...
Exports (in percent of GDP)	283.1	272.6	277.8	260.5	...
Imports (in percent of GDP)	285.9	275.2	279.8	260.3	...
Number of tourists (in millions)	2.8	2.9	3.1	3.2	3.1
Lira US$ exchange rate	1,372.1	1,198.1	1,240.6	1,232.4	1,573.7
Nominal effective exchange rate index 2/	98.5	100.6	98.9	95.7	79.7
Fiscal variables					
Central government revenue 3/ 4/	27.5	25.3	34.7	37.4	36.5 5/
Central government expenditure 3/ 4/	23.9	26.4	32.5	32.5	35.8 5/
Central government balance 3/	3.6	-1.1	2.3	4.9	0.7 5/
Interest rates					
Loans 6/	15.00	14.50	15.15	17.87	14.00
Repurchase agreements 6/	...	...	...	13.00	8.00
Time deposits 6/	8.00	7.95	7.55	10.00	6.50
Italy 3-month interbank rate	...	13.72	12.92	13.85	8.59
Banking system assests and liabilities					
Net foreign assets 1/	...	26.9	24.5	46.2	27.2
Domestic credit 1/	...	33.5	12.3	35.8	6.8
Domestic deposits 1/	...	24.6	24.6	32.1	21.7
Total liabilities	...	31.1	27.9	46.7	22.1

1/ Staff estimate.
2/ Italy's NEER, 1985=100.
3/ In percent of GDP.
4/ Excludes payroll contributions to the Social Security Institute.
5/ Staff estimates based on official projections.
6/ End of period, average.

San Marino: Statistical Issues

There are difficulties with virtually all parts of San Marino's statistical base, but these differ somewhat across different areas. For monetary statistics, data collection does not pose inherent technical difficulties, since there are only four commercial banks. However, the authorities are reluctant, on grounds of bank secrecy, to collect or release some important information: in particular, no data are available regarding the composition of deposits, and other assets and liabilities, as between residents and nonresidents. Banks also have no legal obligation to supply such information. The staff stressed the importance of data on resident deposits, which would be useful as an indicator of current economic activity and monetary conditions in San Marino--whereas nonresident deposits would probably be dependent mainly on developments in Italy. These data are particularly sensitive at this point, however, given the process of negotiation toward the implementation of the Exchange and Financial Accord with Italy. The staff constructed monetary tables on the basis of the available information as well as on numerous assumptions which were discussed with the authorities.

For government finance statistics, the relevant data are collected but are presented in a way that limits their transparency. In the tables published by the authorities, accounting is on an accrual basis and amortization is included in expenditure. During the mission, the staff and authorities transformed the accounts to a cash basis, according to Fund standards. A more fundamental problem, however, is the long delays in settlement of many transactions: in particular, the collection and refunding of tax on imports. Outstanding unsettled receipts and reimbursements have been of the same order of magnitude as annual revenue and expenditure. Given these arrangements, the fiscal balance varies widely from year to year on a cash basis, while on an accrual basis it is difficult to interpret because many accrued receipts and payments may not be settled for years.

San Marino has no balance of payments accounts. It has not committed the resources needed to compile such accounts, given that the currency union makes the balance of payments unimportant as a policy consideration. The mission stressed, however, that it would be useful for other purposes for the authorities to collect data on some key components (merchandise trade, tourist expenditure, and factor services). The July 1992 Fund Membership mission estimated the main components of the balance of payments, using data on exports and imports supplied by the tax office. In the absence of official international reserves, that mission also used government deposits with the Sammarinese banking system as a measure of reserves for the purpose of establishing San Marino's quota. The April 1994 mission has sought to refine these estimates.

In 1992, the authorities presented an experimental set of national accounts. The data underlying these accounts are from the tax office, pertaining to the various components of income, as well as tax receipts from exports and imports. Investment expenditure is treated as a residual. Even given the paucity of data, some important adjustments could be made: including an imputation of the services of owner-occupied housing, which makes up the majority of San Marino's housing stock; and an adjustment of the reported incomes of the self-employed based on tax evasion ratios used in other countries. Such adjustments were discussed with the authorities.

The authorities would like to develop their statistical base and in this connection have expressed a strong interest in statistical technical assistance from the Fund to help them to begin compiling statistics on a sound footing.

San Marino: Fund Relations
(As of April 30, 1994)

I. Membership status: San Marino became a member of the Fund on September 23, 1992. San Marino accepted the obligations of Article VIII, Section 2, 3, and 4 of the Fund Agreement as of September 23, 1992.

II. General Resources Account:	SDR Million	% Quota
Quota	10.00	100.0
Fund holdings of currency	7.65	76.5
Reserve position in Fund	2.35	23.5

III. SDR Department:	SDR Million	% Allocation
Holdings	.06	N/A

IV. Outstanding Purchases and Loans: None

V. Financial Arrangements: None

VI. Projected Obligations to Fund: None

VII. Exchange Rate Arrangements

The currency of San Marino is the Italian lira. The central monetary institution is the Istituto di Credito Sammarinese. Foreign exchange transactions are conducted through commercial banks without restriction at rates quoted in Italian markets. There are no taxes or subsidies on purchases or sales of foreign exchange.

VIII. Article IV Consultation

The first consultation discussions with San Marino since accession to Fund membership were held April 6-15, 1994.

IX. Technical Assistance: None

X. Resident Representative: None