LAPSE OF TIME

SM/20/63
Correction 2

March 25, 2020

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of San Marino—Staff Report for the 2020 Article IV Consultation**

Board Action:	The attached corrections to SM/20/63 (3/9/20) have been provided by the staff:
Evident Ambiguity	**Pages 1, 5, 7 (para. 6, line 8, "significantly"), 18, 44, 52**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 6 and 7 (para. 6, lines 8–10)**
Additional Information:	Page numbers have shifted owing to the correction on page 1.
Questions:	Mr. Klein, EUR (ext. 36706) Mr. Muraki, EUR (ext. 34543) Mr. Dell'Erba, EUR (ext. 35447) Mr. Kaffo, SPR (ext. 38171) Mr. Leonovich, MCM (ext. 37576)

INTERNATIONAL MONETARY FUND

REPUBLIC OF SAN MARINO

STAFF REPORT FOR THE 2020 ARTICLE IV CONSULTATION

March 9, 2020

KEY ISSUES

The Staff Report was prepared by a staff team of the IMF for the Executive Board's consideration on March 27 on a lapse of time basis. The staff report reflects discussions with the Sammarinese authorities in January 2020 and is based on the information available as of January 31, 2020. It focuses on San Marino's near- and medium-term challenges and policy priorities and was prepared before COVID-19 became a global pandemic and resulted in unprecedented strains in global trade, commodity, and financial markets. It, therefore, does not reflect the implications of these developments and related policy priorities. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring the situation and will continue to work on assessing its impact and the related policy response in San Marino and globally.

Context: Banking system vulnerabilities pose considerable stability risks and hinder economic recovery. Significant deposit outflows have left the banking system with low liquidity, while persistent bank losses, poor asset quality, sizable capital shortfalls, led to multiple bank failures in recent years. Recent bank interventions largely relied on regulatory forbearance and state support, which widened fiscal deficits, eroded fiscal buffers, and increased the implicit public debt~~fiscal liabilities~~ to unsustainable levels. The elevated risks, and a shared recognition that a broad coalition is critical to advance the necessary reforms, triggered snap elections in early-December—two years ahead of schedule—and the establishment of a four-party coalition government.

Outlook and risks: With no credible measures to restore banking system health and in the face of a continued weak external environment, economic growth is projected to remain subdued in the coming years. Slow progress in repairing the banking system and failure to restore fiscal sustainability are the key and material risks. The recent outbreak of COVID-19 in San Marino and Italy has significantly increased uncertainty.

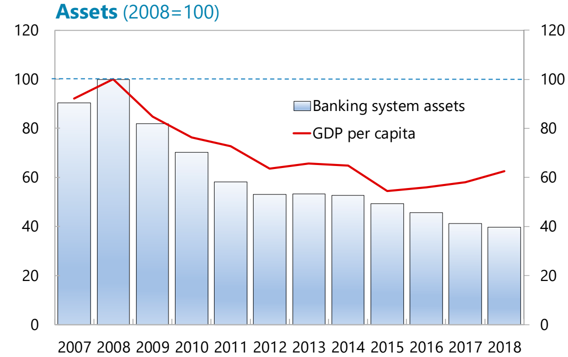
Main policy recommendations: Urgently develop a stabilization plan that safeguards financial stability, restores fiscal sustainability, and removes supply-side bottlenecks to sustained growth:

- **Financial sector:** Safeguard the central bank's liquidity buffers and develop a credible strategy to secure banks' viability and sustainability through upfront loss recognition, recapitalization with burden sharing, deep restructuring with

CONTEXT

1. **San Marino's economy experienced a deep contraction, from which it struggles to recover**. San Marino's offshore banking model, which largely benefitted from banking secrecy, collapsed due to enhanced transparency and anti-tax evasion measures. Bank balance sheets shrank significantly owing to sizable deposit outflows and deleveraging, while poor risk management resulted in a considerable deterioration of banks' asset quality and persistent losses. The financial contraction, coupled with feeble external demand, contributed to a deep and prolonged recession, from which the economy bottomed out in 2015. Yet, the recovery remained weak with GDP-per-capita well below its pre-crisis level.

San Marino: GDP Per Capita and Banking System Assets (2008=100)



Sources: WEO and IMF staff.

2. **Banking sector weaknesses threaten financial stability and fiscal sustainability.** The banking system's low liquidity, high non-performing loans (NPLs), and large recapitalization needs have left the banking system highly vulnerable to shocks while re-current state support to banks—though not properly recognized—led to persistent fiscal deficits and an increase of the implicit public debt ~~fiscal liabilities~~ to unsustainable levels. The weak fiscal position together with the lack of market access and limited central bank of San Marino's (CBSM) liquidity buffers significantly constrain the authorities' policy options if faced by adverse economic conditions.

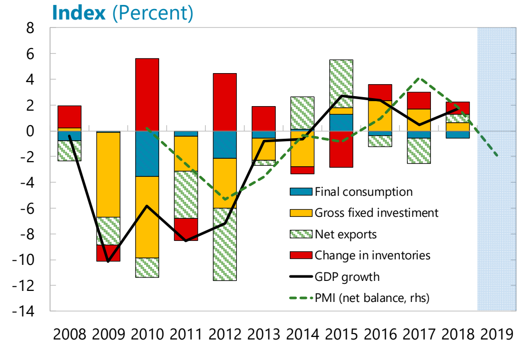
3. **A new government took office in early January with the goal of reviving economic activity.** The Christian Democrats emerged from December elections as the largest party and established a four-party coalition government. The coalition's platform centers on stimulating growth, including by developing technology-based sectors, improving the business environment, and adopting a national strategy for NPL resolution. Priority is also given to ensure public debt sustainability, including by containing current expenditure, modernizing public administration, and reforming the tax system.

RECENT DEVELOPMENTS AND POLICY PRIORITIES

4. **Economic activity remained subdued, keeping the unemployment rate elevated.** Real GDP growth accelerated to 1.7 percent in 2018 from 0.4 percent in 2017 as investment and net exports growth more than offset the contraction of consumption. For 2019, high frequency indicators are inconclusive: while exports of services remained strong and the number of enterprises grew following a prolonged contraction, employment growth, which was mostly driven by non-residents, decelerated up to September and increased only in the last quarter, imports growth moderated, and manufacturing Purchasing Managers Index further weakened. Unemployment rate modestly declined to 7.7 percent from 8 percent in 2018 but remained well above its pre-crisis

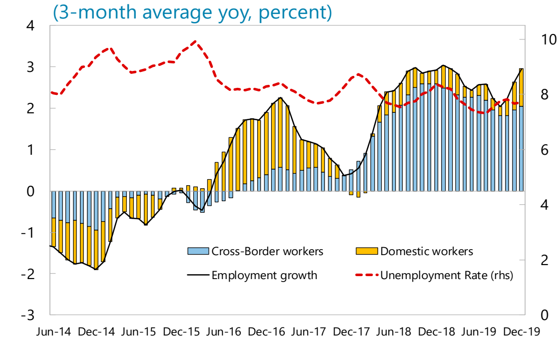
levels. Despite modest improvements in firms' repayment capacity—owing to prolonged deleveraging—the corporate sector remained largely vulnerable with low profitability and high leverage, thus weighing on economic recovery (Annex I).

Real GDP Growth and Purchasing Managers Index (Percent)



Sources: Sammarinese authorities and IMF staff.

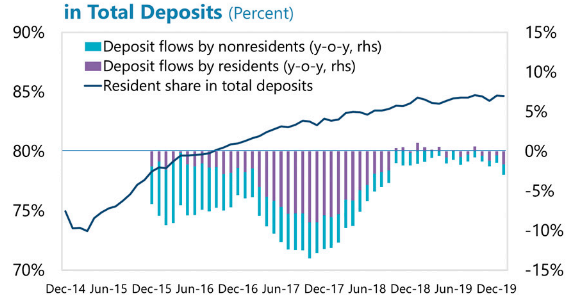
Unemployment Rate and Employment Growth (3-month average yoy, percent)



Sources: Sammarinese authorities and IMF.

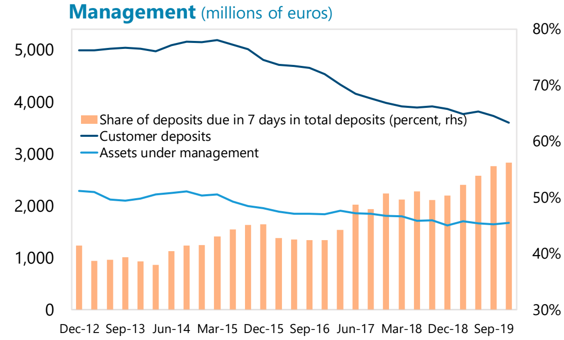
5. **Banking system liquidity remained broadly stable in 2019, but at low levels.** Bank deposits declined slightly in 2019 and they are now at about 30 percent below their 2014 level. Liquidity risks in the banking system are high as the share of short-term deposits (due in seven days) increased to more than half of total deposits, and seven-day liquidity coverage ratios remained at about 30 percent. CBSM reserves increased to €385 million at end-2019 from €223 million at end-2018, mainly due to a temporary shift of part of pension fund deposits from banks into the CBSM, CBSM's divestment of illiquid securities, and the sale of Delta sub-portfolio by the state-owned bank, Cassa di Risparmio della Repubblica di San Marino (CRSM), which contributed to an increase of its deposits at the CBSM. Nevertheless, CBSM's capacity to withstand sizable deposits withdrawals is still constrained as reserves remain inadequate (Annex II).

Deposit Flows by Residency and Resident Share in Total Deposits (Percent)



Note: Customer deposits include certificates of deposits (CDs). In 2019, deposit increases/decreases related to the sales of the Delta subportfolio, reallocation of pension fund deposits between banks and the CBSM, and Banca CIS resolution are excluded from deposit flow data.
Sources: Sammarinese authorities and IMF staff.

Banking System Deposits and Assets under Management (millions of euros)

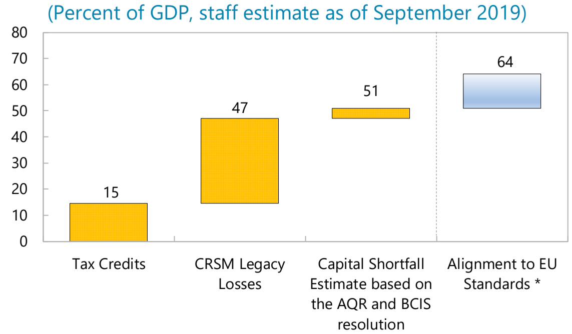


Note: Customer deposits include certificates of deposits (CDs).
Sources: Sammarinese authorities and IMF staff.

6. **The banking system recapitalization needs are sizable, and the recent bank resolution suggests a potential underestimation.** The estimated capital shortfalls, which are based on the 2017 Asset Quality Review (AQR) update, stand at 51 percent of GDP, and mostly concentrated in

CRSM, which, in 2017, the government committed to recapitalize gradually over 25 years. Banks were required to incorporate the AQR findings in their capital calculations for the 2019 financial statements and they are currently evaluating ways to address their capital shortfalls. However, with AQR results becoming outdated, there is a risk that the capital needs are ~~significantly ~~under-estimated~~, as identified during the Banca Credito Industriale Sammarinese (BCIS) resolution~~.

San Marino: Banking System Recapitalization Needs
(Percent of GDP, staff estimate as of September 2019)

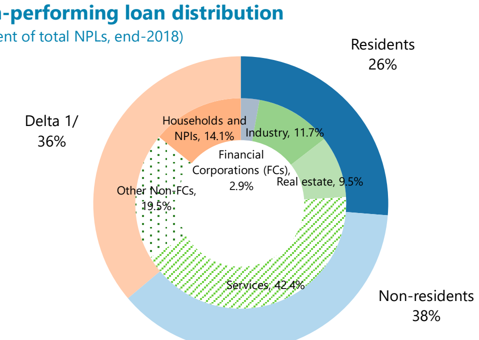


* Higher capital levels will be required under the application of the EU standards.
Sources: Sammarinese authorities and IMF staff.

7. A new bank resolution law was enacted and immediately applied to resolve a failed bank (Box 1). The law, which increases the CBSM's intervention powers, was adopted to support BCIS' resolution. While equity and a small part of uninsured deposits were written-off, the resolution of BCIS also entailed a bailout. The bank's insured deposits, pension fund deposits, a small portion of NPLs, and all performing loans were transferred to other entities, while the remaining structure—renamed as Banca Nazionale Sammarinese (BNS)—was nationalized and recapitalized by converting CBSM Emergency Liquidity Assistance (ELA) claims into equity. A new management team was appointed and the bank has retained its banking license. Nevertheless, BNS has recently halted banking operations and its business model is expected to be re-defined in the coming weeks as most of its assets are not generating income.

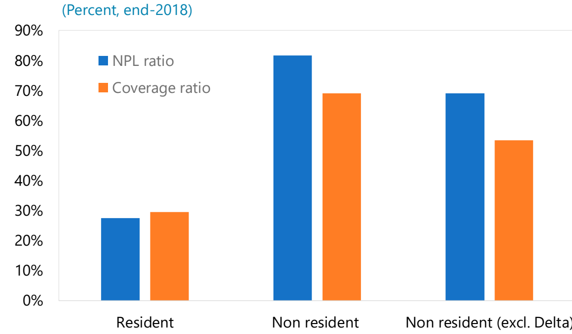
8. Banking system NPLs increased further, accounting for more than half of banks' total loans. The NPL ratio increased further to about 57 percent in November 2019 from 53 percent at end-2018, primarily due to reclassification of BCIS' loan portfolio during its resolution process. Yet, reported NPLs are understated as they do not include NPLs of failed banks that are kept off-balance sheet (in closed funds) and—considering the large volume of ageing NPLs and the significant difficulties in cross-border enforcement of collaterals—they are likely to be under-provisioned. The authorities are planning to speed up NPL resolution through stricter supervisory requirements and creation of an Asset Management Company (AMC) that will manage and recover NPLs.

Non-performing loan distribution
(precent of total NPLs, end-2018)



1/ Delta was an Italian financial company that was owned by CRSM, before liquidated due to anti-money laundering concerns.
Sources: Sammarenise authorities and IMF staff

NPL and Coverage Ratios by Residency/1
(Percent, end-2018)



1/ NPLs figure indicates the pre-AQR ratio.
Source: Sammarinese authorities and IMF staff.

- **Economic integration.** Sustained efforts are needed to increase economic integration and expand market access, including by concluding the EU association agreement, which is expected to simplify procedures for domestic exporting firms. Investment in infrastructure, particularly in the areas of telecommunication and transportation, remains essential to allow firms to expand into higher value-added sectors.

Authorities' Views

30. The authorities broadly concurred with the importance of addressing structural bottlenecks to promote sustainable growth. They agreed that skill mismatch is a critical structural issue and expressed their intension to provide better trainings to residents, including by enhancing cooperation between universities and industries. They also emphasized the importance of attracting foreign investment and stressed their commitment to address infrastructure gaps and improve the ease of doing business, including through reducing red tape, expediting judicial processes, and streamlining regulations. The authorities reiterated their plans to conclude the Association Agreement with the EU, while also strengthening the relationship with Italy to further advance economic integration. Encouraged by recent positive trends in tourism, they are working to promote San Marino as an attractive tourism destination and are exploring ways to upgrade accommodations as well as hosting cultural events and conferences in partnership with the private sector.

DATA

31. Data reporting and provision have improved but more needs to be done. In 2018, the authorities started to produce balance of payment and IIP statistics annually and are making efforts to improve data dissemination, including by implementing the recommendations of the IMF's Enhanced General Data Dissemination System (e-GDDS) and publishing critical data through the National Summary Data Page in January 2020. While data provision is broadly adequate for surveillance, further steps to improve data quality, coverage, and reporting frequency, including by providing greater resources to the Statistical Office, would support policy-making process.

STAFF APPRAISAL

32. Banking sector weaknesses continue to pose stability risks and hinder economic recovery. Significant deposit outflows and weak risk management have left the banking system with low liquidity, poor asset quality, and considerable recapitalization needs, while multiple bank failures and continued state support to the banking system have eroded government liquidity buffers and led to an excessive and unsustainable accumulation of ~~fiscal liabilities~~the implicit public debt. Absent a significant policy change, growth prospects are projected to remain subdued over the medium term with risks heavily tilted to the downside. The recent outbreak of COVID-19 in San Marino and Italy has significantly increased uncertainty. The external position is weaker than implied by fundamentals and desirable policy setting.

Annex VI. Debt Sustainability Analysis

Recent bank interventions have increased ~~fiscal liabilities~~the implicit public debt to unsustainable levels. Staff's baseline scenario, which incorporates the government's excessive commitments to banking system and the pension funds, indicates that public debt increased to 85.8 percent of GDP in 2019 from 78.8 percent of GDP in the previous year mainly due to the recent bailout of BCIS. In the absence of durable fiscal adjustment and in the face of subdued growth prospects, the implicit public debt is projected to climb to 97.1 at the end of the forecast horizon. These levels, which are unsustainable for San Marino given its lack of market access and limited domestic financing sources, underscore the urgent need for an ambitious fiscal consolidation, stronger public debt management, and private sector contributions to banking system recapitalization. While data weaknesses call for caution, persistent capital outflows are projected to set the external debt, which is estimated at 67 percent of GDP in 2019, on a downward trajectory over the medium term.

1. **Public debt, adjusted to include government's commitments to the banking sector and the pension funds, increased further in 2019**. Public debt increased in 2019 to 85.8 percent of GDP from 78.8 percent of GDP in 2018, mainly owing to the recent BCIS bailout. Going forward, public debt is projected to increase further to 97.1 percent of GDP by 2025 on the back of persistent fiscal deficits and weak growth (Figure AVI.1). The 2020 gross financing needs are projected to increase significantly to about 10.6 percent of GDP from 3.7 percent in 2019 due to a larger fiscal deficit and the repayment of a government loan from the CBSM,[1] and—while declining in 2021—they are projected to remain on an upward path throughout the projection period and reach 11.9 percent of GDP in 2025, partly due to re-current state recapitalization of CRSM, which will facilitate a gradual recognition of public debt and thus increase interest payments.

2. **The unsustainable level of implicit public debt calls for an ambitious fiscal adjustment and a restricted public sector contribution to bank recapitalization.** The elevated public gross financing needs pose significant financing risks, given the lack of market access, limited domestic financing sources, and weak debt management capacity. Adverse economic conditions will further amplify these risks (see adverse scenarios below and Figure AVI.3). This underscore the urgent need for an ambitious and durable fiscal consolidation, stronger public debt management capacity, and careful design of a banking sector recapitalization strategy to limit future incurrences of public debt.

3. **The sustainability of public debt is assessed via several adverse scenarios**. The analysis suggests that public debt remains highly vulnerable to negative shocks to GDP growth, the materialization of contingent liabilities, and a set of combined macro-fiscal shocks. In particular:

- *Real growth shock.* Real GDP growth rate is assumed to decline by one-standard deviation below the baseline during 2021–22. Under this scenario, the public debt ratio would increase to 101.4 percent of GDP by 2022, and to 107.5 percent of GDP by 2025.

[1] In the projection, we assume the short-term loan from CBSM is repaid in 2020 by issuing a new 10-year bond with 2 percent interest rate.

PRESS RELEASE

PR[20/XX]

Appendix I. Draft Press Release

IMF Executive Board Concludes 2020 Article IV Consultation with the Republic of San Marino

FOR IMMEDIATE RELEASE

WASHINGTON, DC – March xx, 2020

On [March 27, 2020] the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with the Republic of San Marino and considered and endorsed the staff appraisal without a meeting on a lapse-of-time basis[2] (see below an important note on the timing of the report which precedes the outbreak of COVID-19).[3]

San Marino is now facing very significant challenges owing to the recent COVID-19 outbreak, which has taken a heavy toll on local population and businesses. The authorities' near-term efforts are rightly focused on limiting and containing the adverse social and economic effects of the COVID-19 outbreak.

Medium-term growth prospects are projected to remain weak as tight credit conditions and a substantially weaker external environment will constrain the recovery. The high uncertainty around the extent and length of the COVID-19 spread, the current lack of external market access, and the limited central bank liquidity buffers suggest that the balance of risks is heavily tilted to the downside. San Marino's key medium term challenge is to address the elevated macro-financial vulnerabilities emanating from the weak banking system liquidity and capital positions, poor asset quality, and high cost-to-income ratios as well as low government's liquidity buffers and an excessive accumulation of fiscal liabilities.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

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

[3] The staff report reflects discussions with the Sammarinese authorities in January 2020 and is based on the information available as of January 31, 2020. It focuses on San Marino's near- and medium-term challenges and policy priorities and was prepared before COVID-19 became a global pandemic and resulted in unprecedented strains in global trade, commodity, and financial markets. It, therefore, does not reflect the implications of these developments and related policy priorities. The outbreak has greatly amplified uncertainty and downside risks around the outlook. Staff is closely monitoring the situation and will continue to work on assessing its impact and the related policy response in San Marino and globally.