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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 19/21-1

3:15 p.m., March 22, 2019

1. Republic of San Marino—2019 Article IV Consultation

Documents: SM/19/50 and Correction 1; and Supplement 1; and Supplement 1, Correction 1

Staff: Klein, EUR; Sun, SPR

Length: 40 minutes

Executive Board Attendance

M. Furusawa, Acting Chair

Executive Directors	Alternate Executive Directors
	T. Sitima-wina (AE), Temporary
	F. Sylla (AF)
	E. Rojas Ulo (AG), Temporary
	G. Kim (AP), Temporary
	F. Benoit (BR), Temporary
	X. Cai (CC), Temporary
	J. Montero (CE), Temporary
	P. Mooney (CO), Temporary
	C. Just (EC)
	M.Gilliot (FF), Temporary
	K. Merk (GR)
S. Gokarn (IN)	
D. Fanizza (IT)	
	Y. Saito (JA)
	K. Badsi (MD), Temporary
	D. Fadhel (MI), Temporary
	S. Harutyunyan (NE), Temporary
	J. Sigurgeirsson (NO)
	S. Potapov (RU), Temporary
	R. Alkhareif (SA)
	K.Tan (ST)
P. Inderbinen (SZ)	
	M. Chen (UK), Temporary
	M. Svenstrup (US), Temporary

H. Al-Atrash, Acting Secretary
H. Malothra, Summing Up Officer
E. Mannefred, Board Operations Officer
L. Nagy-Baker, Verbatim Reporting Officer

Also Present
European Central Bank: K. Nikolaou, R. Rueffer. European Department: J. Decressin, S. Dell'Erba, N. Klein, K. Muraki, D. Velazquez-Romero. Legal Department: G. Otokwala. Monetary and Capital Markets Department: D. Monaghan. Strategy, Policy, and Review Department: F. Comelli, Y. Sun.

Alternate Executive Director: M. Psalidopoulos (IT). Senior Advisors to Executive Directors: S. Evjen (NO), F. Spadafora (IT). Advisors to Executive Directors: W. Al Hafedh (SA), L. Cerami (IT), E. Ondo Bile (AF), R. Pandit (ST), A. Urbanowska (SZ), N. Vaikla (NO).

1. REPUBLIC OF SAN MARINO—2019 ARTICLE IV CONSULTATION

Mr. Fanizza and Mr. Spadafora submitted the following statement:

The authorities of the Republic of San Marino reiterate their appreciation for the candid and cooperative discussions held with Fund staff during the Article IV consultation and very much value their recommendations, tailored advice and technical assistance. The authorities broadly concur with the staff's analysis and will continue to rely on the Fund's recommendations to safeguard financial stability and strengthen growth.

Economic growth slowed down in 2017 but is expected to recover in 2018, albeit at a moderate pace of around 1.1 percent, held back by subdued domestic and external demand. After peaking at 10 percent in early 2016, the unemployment rate has declined to around 8 percent, with important recent employment gains – 4 percent in the private sector with respect to 2017, mostly for cross-border workers – supported by the approval of the "Development law" in 2017. There is evidence, albeit not yet captured by formal statistics, of increasing dynamism of the real economy. Local private investors continue to favor San Marino as their preferred location to do business, as proved by the increasing number of new investment projects.

The Sammarinese authorities broadly concur with the staff's assessment of the economic outlook and related risks, although they see room for growth upsides. They are aware that overcoming the persistent vulnerabilities in the banking sector – while preserving fiscal sustainability – remain an urgent priority to remove impediments to faster growth. However, the authorities intend to act with extreme caution, as San Marino lacks an independent monetary policy and is extremely vulnerable to sudden capital outflows to neighboring Italy in case of a shock.

The authorities remain nevertheless confident that structural reforms – notably further steps to improve the business climate – as well as ongoing infrastructural investments – a 5G telecom network will be ready by the end of 2019 – can help attract foreign investments and place the economy on a higher growth path. Structural reforms can also generate a positive effect on the State accounts, thus allowing the State to reimburse the Central Bank of San Marino's (CBSM) loans and restore its reserves.

Besides, economic prospects are expected to receive a boost from the conclusion of the association agreement with the EU – which could be finalized before the end of 2019, as announced at the high-level meeting held on March 5th and 6th in Brussels – and the signing of a Memorandum of Understanding with the Bank of Italy. The authorities intend to accelerate the implementation of the reform agenda defined in the Financial Sector Strategy recommended by the IMF to boost competitiveness and place the economy on a sustainable growth path, thus avoiding the "muddling-through" scenario envisaged by the staff.

Financial Sector

The authorities recognize that delays in acting to repair the banking system endanger financial stability and that strengthening banks' liquidity and capital positions remains an urgent priority. They agree that advancing NPL resolution is critical and that private banks should first attempt to raise capital from private sources. They encourage the finalization of systemic projects aimed at effective NPLs reduction in order to decrease banks' credit risks.

The Government remains committed to supporting the CBSM's role in the comprehensive Financial Sector Strategy aimed at restoring financial stability through banks' recapitalization (following the Asset Quality Review-AQR results), their organizational and governance restructuring and effective NPL reduction. The authorities intend to boost the effectiveness of the Financial Sector Strategy by enhancing the CBSM's supervisory powers and removing legal, regulatory and tax impediments to NPL resolution.

The authorities emphasize that the staff's inclusion of tax credits in computing the implicit public debt is a choice that contradicts standard accounting criteria: tax credits technically become public debt only if and when converted into government bonds and this is not the case for San Marino. The staff's projections of the level of the implicit public debt are based on the assumption of public intervention to cover all the financial needs of the banking system, a scenario that the authorities do not consider as being applicable with certainty.

The authorities underscore that the ongoing AQR disclosure process, which will lead to the recapitalization of banks, and the measures adopted by the CBSM to improve the monitoring and management of the liquidity in the banking system are important steps towards restoring its health. Strengthening relations with the Bank of Italy would improve CBSM Supervision and lead to the signing of the Memorandum of Understanding (MoU).

As the main shareholder of Cassa di Risparmio della Repubblica di San Marino (CRSM), the Government is aware of the need to reduce losses, recapitalize and restructure the bank for it to regain its ability to finance the real economy. The authorities broadly agree with the staff's approach on how to address capital shortfalls in the banking system. They also support a faster NPL resolution as a key step to restore long-term viability of banks: to this end, full liberalization of the real estate market and the new legislation to facilitate out-of-court debt restructuring are some of the initiatives already delivered by the Government.

The CBSM highlights the urgency of improved powers and tools to enhance the bank resolution framework in order to effectively deal with failing supervised entities and reduce potential fiscal costs.

The authorities acknowledge the impending need for banks to improve efficiency and restore viability, including by reducing operational costs substantially, including labor costs, and rationalizing the branch network.

The authorities have major concerns on the staff's suggestion to apply burden sharing, including to subordinated debt, due to San Marino's specificities, an enclave in Italy; they also believe that a full guarantee of the Institute of Social Security's (ISS) pension deposits is necessary to boost confidence and relieve liquidity pressures.

San Marino's authorities underscore the transposition of the 4th EU Anti-Money Laundering (AML) Directive into national laws and the strengthening of AML/CFT legal and regulatory frameworks. Following the results of the AML National Risk Assessment and Action Plan, the authorities indicate that they have adopted regulatory measures on sound management in relation to ML/TF risks, which contain provisions related to corporate governance and financial integrity, reiterating the importance of the "tone at the top". The OECD Global Forum, in a recently published peer review report on the Exchange of Information on Request, has upgraded San Marino's overall rating from "Largely Compliant" to "Compliant". To continuously understand and mitigate financial integrity ML/TF risks, the authorities are currently undertaking a second National Risk Assessment, which is planned to be completed by the end of 2019.

Moreover, the EU has removed San Marino from its tax haven gray list, following the updating of the Annex 2 (Fair Taxation – 2.1 Existence of harmful regimes) published by the EU Code of Conduct, on 20 December 2018. Among the criteria used by the EU, one is the fact that the minimum standards of the OECD’s Base Erosion and Profit Shifting (BEPS) project are being implemented. In 2016 San Marino joined the OECD’s new inclusive framework to tackle BEPS. The positive evaluation (as “Not Harmful”) obtained in October 2018 during the Forum on Harmful Tax Practices meeting for the Action 5’s BEPS peer review, was fundamental for the evaluation by the EU Code of Conduct.

Fiscal Policy

The authorities recognize the need to address the fiscal risks related to banking system repair and concur that growth-friendly fiscal reforms are needed to ensure debt sustainability. They note that, despite the State support to the CRSM, mainly to cover the 2017 loss, the overall fiscal deficit is projected to have narrowed in 2018 by about 1 percentage point – to 2.7 percent of GDP – on the back of adopted one-off measures.

The 2019 budget approved in December 2018 aims at achieving a broadly balanced position, net of government transfers to CRSM. To this end, the budget introduces new measures, which are projected to partly offset the measures expired in 2018.

The authorities agree that an ambitious fiscal adjustment, with measures on both the revenue and expenditure side, is needed to put public debt on a sustainable path and gradually build fiscal buffers. To this end, the authorities plan to replace the single-stage import tax (Monofase) with a value-added tax (VAT) in 2020 as a way to remove distortions and yield additional revenues.

The authorities are finalizing a pension reform that aims at containing transfers to the ISS, safeguarding the pension system’s sustainability and achieving budget savings. Elements of this reform include the postponement of the retirement age and the transition to a more sustainable system of pension calculation. The authorities are also developing a wealth indicator for households to facilitate a better targeting of social benefits and strengthen the ISS financial standing. They are conducting a spending review to improve efficiency across government units. In the health sector, which is based on the principle of universal coverage, the introduction of a new approach based on prevention and enhanced monitoring will set health expenditure on a more moderate rising trend.

The authorities also note the challenging political environment and the need to achieve broad agreement with social partners to ensure a successful implementation of indirect taxation and pension reforms.

Structural Reforms

In pursuing the objectives of internationalizing and diversifying the economy, the authorities remain committed to tackling structural impediments to faster growth; they underscore the improvement in San Marino's Doing Business score in recent years and the role played by the Development Law in supporting employment. Further benefits are expected from the recently-established Office for Active Labor Market Policies, which will be instrumental in enhancing training and job searching as well as in better targeting social benefits.

The authorities place a particularly high value on making further progress towards integration with Italy and the EU, which would provide domestic companies with better opportunities to expand market access and operate abroad. To this end, an Economic Development Agency has been recently set up, also with a view to promoting foreign direct investments and tourism. The latter is deemed to be a sector with untapped potential and plans are being prepared to boost hotels' capacity and develop skills.

In the face of tight budget constraints, the authorities have chosen to support higher private investment, including in innovative sectors, by alleviating firms' loan interest payments, expanding tax incentives, reducing red tape, and utilizing public-private partnerships.

The authorities emphasize that important investments have already been made to upgrade infrastructure in telecommunication, which along with improved transportation will help increase the business connectivity with trading partners and promote competitiveness. Further benefits, notably a simplification of the operations of Sammarinese firms abroad, are expected from the conclusion of the Association Agreement with the EU.

Authorities are convinced that San Marino has an unexploited growth potential and intend to accelerate a rapid transformation of its economy. To this purpose, they are actively seeking financial partners that could support infrastructural and innovative projects and contribute as well to an upgrade of the industrial and financial sectors. Discussions are ongoing with several interested parties.

With a view to supporting sustainable and equitable growth in the long term, the Government intends to promote a reflection on the future of the Sammarinese economy that could serve beyond the terms of its mandate. This new initiative will be launched in the coming weeks and will engage the civil society at large, including representatives of the main productive sectors of the economy.

Finally, the authorities would like to once again thank Fund staff for the provision of relevant technical assistance, which has allowed to greatly improve the production of statistics on the balance of payment and International Investment position.

Mr. Lopetegui and Mr. Rojas Ulo submitted the following statement:

We thank staff for the candid reports and Mr. Fanizza and Mr. Spadafora for their helpful buff statement.

The economy of San Marino is showing signs of a slow recovery and the outlook remains challenging amid calls for the implementation of appropriate structural policies to promote sustained economic growth. After the country experienced a severe recession in recent years, caused by an implosion of the financial sector and weak external demand, the economy started to rebound but the pace has been subdued. Economic growth is projected to slow down from 1.2 percent in 2018 to 0.8 percent in 2019 and gradually reduce and stabilize at 0.5 percent in medium term and show the necessity to implement key policies to support economy activity. We concur with the report's recommendation on the urgent need to implement policies to restore banking sector health and safeguard public finances to promote sustained growth.

A broader fiscal strategy to achieve fiscal consolidation, rebuild fiscal buffers, and put public debt on a sustainable path to growth is needed. Efforts that limit state contributions to restore the banking system and limit the fiscal deficit toward more credible fiscal adjustment should continue, along with the reforms to increase tax revenue, improve the efficiency of spending, and develop debt management capacity. In this context, we support the authorities' initiatives for strengthening debt management capacity and diversifying sources of financing. We also support the additional reforms on the fiscal side such as reforming budget formulation, strengthening macro-fiscal planning, and enhancing fiscal transparency.

Efforts to strengthen the banking system and an adequate regulatory framework for stronger supervision and reduced risk are required. Deposit outflows weaken the banking system liquidity which remains at a highly vulnerable level. Persistent losses due to high operating costs, non-performing loan (NPL) costs, and non-interest-bearing tax credit, add to the fragile position of banks' capital and show weak profitability. The authorities should continue actions to ensure the restructuring of the banking system to improve confidence, reduce the high level of NPLs, restore financial intermediation, and increase resilience of the economy. We support the review of the central bank law to enhance independence, governance, accountability, and transparency.

We support the implementation of structural reforms which address structural weaknesses to improve the resilience of the economy. San Marino's economy has particular characteristics, including an open economy, and it is highly vulnerable to external shocks from the financial sector. We encourage the authorities to continue their efforts and accelerate the implementation of structural reforms focused on strengthening social benefits, labor supply, and improving the business climate. In this direction, we support reforms that increase economic integration such as with Italy and the EU, reduce the infrastructure gap, and increase foreign investment to promote sustained economic growth.

With these comments, we wish San Marino and its people success in their future endeavors.

Mr. Sigurgeirsson and Mr. Evjen submitted the following statement:

We thank staff for the report and Mr. Fanizza and Mr. Spadafora for their informative buff statement. We concur with the thrust of the staff appraisal. Long-lasting and severe weaknesses in the banking system are threatening financial stability and fiscal sustainability, in turn undermining economic activity. San Marino's key challenges are to restore banking system viability and credit supply, safeguard public finances, and promote sustained growth. Hence, a comprehensive strategy is needed.

Financial sector and financial stability. Banks' capital needs should be promptly addressed, and liquidity positions strengthened. The recapitalization needs are sizeable. We agree with staff that a mix of private and public contributions may be necessary for the capitalization. To this end, it's important that the amount of state support be guided by fiscal sustainability considerations. We would also stress the importance of the principle that only systemically-important banks should benefit from state support. Strengthening financial sector oversight, including through a comprehensive overhaul of the bank resolution framework, will also help safeguard financial stability and the fiscal position. Lastly, we fully agree that reviewing the CBSM law with a view of enhancing its independence, governance, accountability, and transparency should be a priority.

Recognizing the severe challenges in the banking sector, we agree with staff that a deep banking system restructuring is urgently needed to increase efficiency and restore profitability. The system is overbanked, and the cost-to-income ratio is very high compared with banks in other countries, suggesting serious inefficiencies. Improved efficiency should focus on a significant cost reduction. Advancing NPL resolution should also be prioritized as a key to restore long-term viability of banks and support financial intermediation.

Fiscal policy and debt sustainability. We agree that an ambitious and growth-friendly fiscal consolidation is needed. Fiscal adjustment should rely on both revenue and expenditure measures. Noting that the tax-to-GDP ratio is well below peers, we call for measures to broaden the tax base. We welcome the VAT reform which will help yield additional revenues if implemented with sufficiently high rates and without many exemptions. We also note the staff view that significant savings could be achieved by pension reforms, including by delaying the retirement age and transitioning into a defined contribution system.

Structural reforms. We encourage the authorities to continue addressing structural weaknesses to increase competitiveness, reduce vulnerabilities, and bolster potential growth. We agree that strengthening the labor supply, improvements in the business climate, and better targeting of social benefits are among the factors that may help boosting medium-term growth.

The authorities' efforts to strengthen the AML/CFT frameworks following the AML National Risk Assessment and Action plan should continue. The efforts to improve data provision should be sustained.

Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their comprehensive report and Mr, Fanizza and Mr. Spadafora for their insightful buff statement. We broadly concur with staff's overall assessment and wish to add the following remarks for emphasis.

Outlook and risks

San Marino’s growth prospects are dampened by deeply anchored legacy problems of the banking sector and downside risks mainly reflected in the fiscal and financial vulnerabilities, debt sustainability concerns, lesser favorable external conditions and an external position weaker than implied by fundamentals. The weakening in the demand from Italy, which accounts for 86 percent of the country’s exports and 61 percent of the tourists, is likely to contribute to the slowdown in 2019. In this regard, we would welcome staff’s assessment of the impact of the technical recession by end 2018 in Italy on San Marino’s growth and fiscal policy.

Financial sector

Continued efforts to deleverage and restructure further the banking sector and restore credit supply are essential to help the financial sector deliver on its full potential on growth and mitigate financial stability and fiscal risks. Full loss recognition of contingent liabilities and banks’ substantial recapitalization need to be carefully designed to avoid public debt unsustainability while restoring financial intermediation and increase banks’ resilience to shocks. In this respect, converting tax credits held by banks into government bonds could help preserve the viability of the system. Capital and liquidity levels should be raised and high NPL levels addressed urgently to restore public and investors’ confidence. We also agree with staff that reducing banks’ operating costs could be helpful to buildup capital through internal means as market access is still limited. We can only be supportive of reforming the Central Bank of San Marino (CBSM) by enhancing its supervision and regulatory powers, ensuring its full independence and providing the institution with adequate resources to fulfil its missions. We however salute the engagement of the country in international cooperation. The Association Agreement with the EU which should be concluded by early 2020 will be beneficial to the banking sector. In the meanwhile, we encourage the authorities to abide by the European prudential regulations (before transposition this year), in particular in terms of state support to viable banks which should occur following burden sharing.

Fiscal policy

Ensuring public debt sustainability is paramount given the state’s high level of contingent liabilities linked to the banking sector. We appreciate staff’s debt sustainability analysis (Annex V) and note that the fiscal costs of the government’s commitment to amortize the Cassa di Risparmio della

Repubblica di San Marino (CRSM) legacy losses[1] and of banking system tax credits given to banks to cover the asset-liability gap when they absorbed failed banks are not taken into account, as underlined in the Annex. This leads to divergence in the assessment of the public debt level as the estimated implicit public debt of about 77 percent of GDP in 2018 instead of the official level of 27,5 percent of GDP. The incorporation of estimated interest payments of the implicit debt would lead to a significant increase in gross financing needs (to about 8 percent of GDP as mentioned in the report), and in case of realization of contingent liabilities to an increase in public debt to about 100 percent of GDP by 2024. The state's allocation to CRSM of a financial support (€10 million) in order to amortize its legacy losses is a good step forward although it is expected to result in an increase in the overall fiscal deficit of 2,4 percent of GDP in 2019. However, in order to ensure public debt sustainability, we strongly encourage the authorities to carefully design a scheme for banking sector recapitalization.

On the state's budget, the implementing an ambitious, durable and socially acceptable fiscal adjustment is critical to strengthen revenues. We thus support the authorities' strategy to replace the Monofase (single-stage import tax) and introduce instead the VAT in 2020. To ensure success of its implementation, additional measures related to the restructuring and re-training of the Tax Office workforce, the mitigation of tax avoidance and evasion and the broadening of global tax base would be required. The setting up of a Treasury department in 2020 and the reform in budget formulation and the enhancing of macro-fiscal planning and fiscal reporting would help improve public debt management. Lastly, on the expenditure side, reforming the current pension system is critical to ensure its sustainability. Moreover, the government's proposal to incentivize the use of complementary pension systems could be consistent if linked for instance to the level of the pension benefits.

Structural reforms

Sustained efforts need to be made to strengthen labor supply and address infrastructure weaknesses, in particular in services like telecommunication and transportation to improve business connectivity with trading partners. In this regard we agree with staff's appraisal on the timeliness of the National Stability and Development Plan, which beyond the reform of the pension system, also aims at better specializing the economy on tourism, trade and high value-added manufacturing. This Plan will certainly

[1] Legacy losses stand at €465 million over a period of 25 years.

contribute to enhance the economy's external competitiveness by improving corporate governance, streamlining the judicial processes while reducing red tape as well as other structural impediments to enhance the attraction of cross-border businesses and workers. In the same vein, we welcome the Development Law that smooth the functioning of the labor market and encourage the authorities to proceed further to reduce skill mismatches, support higher employment and increase productivity. We finally salute the progress made in enhancing data provision and encourage the authorities to further improve the quality, the frequency and the reporting of relevant statistics.

Mr. Saito and Mr. Naruse submitted the following statement:

We thank staff for the comprehensive reports and Messrs. Fanizza and Spadafora for their informative statement. We note that economic activity has yet to recover from the sharp downturn in the past decade. We are concerned about the staff's assessment that the banking system remains fragile; banks' liquidity remains at highly vulnerable levels, the banking system's recapitalization needs are sizable, and asset quality is low. We agree with the staff's view that actions are needed to restore banking sector viability and credit supply as well as safeguard public finances. Also, we support the authorities' steps to improve the business climate which could help attract foreign investment and shift the economy to a higher growth path. As we agree with the thrust of the staff's appraisal, we would like to make a few comments for emphasis.

Financial Sector Policy

We encourage the authorities to address their banking sector vulnerabilities and deepen banking system restructuring, including through cost reduction and durable resolution of NPLs, strengthening banks' capital and liquidity positions, and improvement of financial sector governance and oversight. We agree with the staff's view that the CBSM reserves should be brought to adequate levels, including by aligning the ELA framework with best practice and restricting the CBSM budget financing to only exceptional needs and on a temporary basis. Could staff share the modalities of the current ELA framework? Also, we note with concern that the CRSM is significantly undercapitalized. We concur with the need to recognize losses as well as recapitalize and restructure the bank so that it returns to viability and contributes to the real economy. In this regard, we note that the authorities underline that domestic resources for banking system repair are insufficient and noted their intention to seek external financing. Could staff elaborate on the potential financing sources? In addition, improving efficiency and profitability as well as advancing NPL resolution are important to support financial intermediation. Could staff elaborate on the background of high NPLs? Also, in what kind of sectors have NPLs been accumulated? Lastly, we agree with the staff's appraisal that steps to strengthen financial sector oversight and further reduce risks would help safeguard financial stability. We believe that bringing the CBSM resolution framework to international standards would be important to enable more effective interventions. Also, we expect the authorities' continuous efforts to mitigate financial integrity risks.

Fiscal Policy

Credible revenue and expenditure measures are needed to put public debt on a sustainable path and gradually build fiscal buffers. We are concerned that the projected state transfers to CRSM are likely to result in a sizable deficit in 2019. Therefore, we see the need for fiscal measures to safeguard public finances and ensure debt sustainability. We support the authorities' plan to increase tax revenue, including through the rationalization of wasteful tax rebates. Also, we note the authorities' plan to introduce the VAT in 2020. While we saw some benefits from adopting the VAT, such as the wider tax base, we also note the staff's assessment on implementation challenges, such as tax administration capacity. Do staff think that two IMF technical assistance missions have sufficiently addressed these issues and the authorities will be able to smoothly implement the VAT? In addition, as staff say, we encourage the authorities to improve debt management capacity and spending efficiency across government units.

Structural Reform

We expect the authorities' sustained efforts for promoting a sustained economic growth. We encourage the authorities to reduce structural impediments for better attracting foreign investment and improving external competitiveness. Also, we see merit in strengthening labor supply further, including by removing the restrictions on hiring nonresidents and reducing the skill mismatches. Lastly, we agree with the importance of addressing infrastructure gaps to increase competitiveness and help expand market access.

Mr. Doornbosch, Mr. Tan, Ms. Harutyunyan and Ms. Pandit submitted the following statement:

We thank staff for the comprehensive report and Mr. Fanizza and Mr.Spadafora for their insightful buff statement. San Marino continues to face significant challenges with weak growth momentum and severe financial sector vulnerabilities. Low liquidity, high NPLs and poor asset quality threaten the Sammarinese financial stability. Moreover, the state's substantial commitment to the banking sector may make fiscal debt unsustainable in the event of state support for recapitalization. This underscores the need for a comprehensive and decisive set of measures to strengthen banking sector resilience and revive economic growth. In this vein, we welcome the authorities' reforms in the labor law, pension, and other structural areas. We broadly agree with the thrust of staff's appraisal and would like to offer the following comments for emphasis.

Banking and financial sector reforms are paramount to safeguard financial stability. We note that the Sammarinese banking system remains fragile with low liquidity, poor asset quality and high NPLs. This poses substantial risks to financial and fiscal stability. In this regard, durable NPL resolution is crucial for long-term bank viability. We stress the importance of deep restructuring and appropriate downsizing to improve banking efficiency and governance, safeguard public finance, and reinvigorate market confidence and lending in the real economy. To mitigate against moral hazard and fiscal risks, we also concur with staff that state support for recapitalization should only be extended to systemically-important and viable banks to the extent feasible, and with burden sharing from private equity injections.

A strong and independent central bank is crucial for effective oversight of the financial system. We share staff's view on the urgent need to strengthen financial sector governance and oversight to curb the build-up of risks. Enhancing the operational independence and supervisory capacity of the central bank to exercise effective supervision and oversight is crucial. In this regard, we encourage the authorities to review the CBSM law to promote greater independence, accountability and transparency of the central bank while enhancing the framework for the regulation, supervision and crisis management of the banking sector.

Fiscal consolidation with gradual adjustment should continue to rebuild buffers. While we take positive note that the 2019 budget adheres to a balanced position, increasing contingent liabilities pose fiscal challenges. The state allocations to recapitalize CRSM along with outstanding tax credits create significant fiscal debt pressures on the banking system. We emphasize that revenue enhancement combined with expenditure adjustment is crucial to ease the fiscal stress. We agree with staff on a broader fiscal strategy to keep public debt on a sustainable path and to build up fiscal buffers. We also call for credible fiscal adjustment based on expenditure rationalization and swift reforms geared towards spending efficiency. We welcome the authorities' plans on indirect taxation, including replacement of the single stage import tax by VAT in 2020 and rationalization of the tax rebate system. On the expenditure side, the combination of new pension reform proposals with comprehensive spending reviews is a good step forward.

Commitment to ongoing structural reforms is critical to maintain sustainable economic growth. We commend the Sammarinese authorities for their notable efforts to mitigate the financial integrity risks. We note that this led to the upgrade of San Marino's overall rating while the EU removed the country from its tax haven gray list. While there are improvements in San Marino's Doing Business score, reflecting gains from the integrity and development fronts, challenges remain due to bureaucratic inertia, judicial impediments and weak corporate governance. We commend the authorities for easing the nonresidents hiring process. At the same time, we see merit in addressing the mismatch of labor skills and alleviating capacity constraints. We also welcome the newly established economic development agency to increase market access and promote higher foreign direct investments.

With these comments, we wish the authorities every success in their future endeavors.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its candid report and Mr. Fanizza and Mr. Spadafora for their useful buff statement. We fully support staff's appraisal and policy priorities and note with concern that a significant policy adjustment is urgently needed to shift San Marino to a sustainable path of growth and prosperity. We would like to offer the following comments for emphasis.

We note that growth is projected to remain subdued in the coming years amid persistent banking system fragilities, which are also undermining financial stability and fiscal sustainability. Indeed, as highlighted by staff's DSA, a measure of public debt that includes contingent liabilities linked to bank recapitalization and restructuring would put the debt ratio at about 77 percent of GDP in 2018. This level would be assessed as unsustainable for San Marino given its limited domestic funding options, lack of market access and weak debt management capacity. The authorities are cognizant of the severity of these challenges and are striving to find a feasible solution that factors in the constraints set by different local stakeholders. However, this approach, along with limited administrative capacity, has achieved insufficient progress so far.

The recently updated Asset Quality Review (AQR) estimates a capital shortfall of at least 39 percent of GDP (€540 million) under the application of the Sammarinese capital requirements, which are weaker than international standards. Alignment to EU standards, which are expected to be phased in starting in 2019, would imply a capital shortfall of about 57 percent of GDP. Besides, the recapitalization should also consider how to treat banks' tax credits amounting to 15 percent of GDP—although we take note of the disagreement with the authorities on this issue. In this context, the authorities recognize that domestic resources for banking system repair are insufficient and note their intention to seek external financing. Could staff comment on where this external financing might come from? We take note of the disagreement between staff and authorities regarding the role of burden sharing in addressing capital shortfalls. As we stressed in the past, we underscore the importance of ensuring that shareholders and subordinated debt holders contribute to loss absorption before injecting fresh capital. However, we acknowledge that, in some cases, this may create material negative side effects that make this option unfeasible. Could staff offer an explanation on why the authorities are so worried about burden sharing? Could staff provide an estimate of the potential contribution from burden sharing to the recapitalization process?

During last year's Art. IV Consultation, staff remarked that the authorities were considering a Fund-supported program as one of the options on the table to address the clean-up of the banking system. Fund engagement could catalyze external financing and, for a microstate such as San Marino, provide support in the design of a reform agenda and the technical expertise needed to manage such a complex process. At that time, it was deemed as premature for the staff to assess the parameters of a potential Fund-supported program, given the lack of information on financing needs and the existence of some data gaps. After the progress made over last year in enhancing data provision and in completing the AQR, those information gaps seem to have been bridged. Could staff elaborate on the possibility of a Fund-supported program to address San Marino's financing needs?

Ms. Pollard and Ms. Svenstrup submitted the following statement:

San Marino's economic outlook continues to be undermined by the collapse of its offshore banking model, which caused deep-rooted legacy banking sector problems. High NPLs and elevated operating costs have eroded banks' capital and viability, leading to multiple bank resolutions over recent years, but the losses have not been properly recognized and absorbed. These weaknesses dampen credit conditions, undermine economic activity, and raise fiscal fragilities. In this context, we broadly agree with staff's analysis and policy recommendations.

We welcome the authorities' intention to implement a reform agenda to put the country on a more sustainable growth path, as articulated in Mr. Fanizza and Mr. Spadafora's buff Statement. While structural reforms can eventually help put the economy on a higher growth path, we stress that any credible reform strategy must begin with a comprehensive package of upfront measures to put the vulnerable banking sector on sound footing. We urge the authorities to work swiftly to implement measures in this regard.

In particular, we welcome staff's recommendations to enhance the Central Bank of San Marino's (CBSM) liquidity buffers, strengthen CBSM's regulatory and supervisory tools, address capital shortfalls, resolve NPLs, and improve the efficiency and profitability of the banking sector. We also agree with staff's emphasis on the need to address CSRM's undercapitalization to support confidence and the need to continue their efforts to strengthen AML/CFT frameworks. Staff note that higher capital levels will be required under the application of the EU standards, which are due to be transposed in 2019 with a yet-to-be-determined transition period. Can staff discuss when in 2019 they expect such standards to begin and whether they foresee issues with compliance? Further, the authorities argued that "the conclusion of the association agreement with the EU and signing of Memorandum of Understanding with the Bank of Italy could have significant benefits." Could staff provide additional details on the near-term feasibility and potential impacts of these two actions?

At the same time, a meaningful fiscal consolidation will be needed to put debt on a more sustainable path. We support staff recommendations to broaden the tax base, given that tax revenue as a percent of GDP is well below the level of San Marino's peers. We welcome the authorities' plans to engage closely with social partners on tax and pension reforms to ensure successful implementation.

Finally, we would appreciate any updates from staff on discussions on a Fund-supported program for San Marino, per press reports late last year. In the absence of an agreement on a program or other bilateral assistance, we would welcome more context on contingency plans to support the banking sector and broader reform agenda.

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their well-focused report, and Messrs. Fanizza and Spadafora for their informative buff. One of the most significant issues facing San Marino is to address the ongoing legacy issues in the banking sector, which have persisted for years. A solution that minimizes the cost to taxpayers, safeguards the financial system and provides for effective credit intermediation to facilitate growth is crucial. Given the shared perspective on fiscal and structural issues between staff and the authorities, we will limit our comments and questions to the financial sector.

Placing the banking sector on a sound footing and ensuring financial stability should be the key priority. We agree with staff that rapid progress on banking system restructuring is critical to restore viability. We agree that recapitalization should happen expeditiously, but it is important that market-based solutions be sought in the first instance and public capital support should only be provided to viable, systemically important banks, following burden sharing. We note that the CBSM's bank resolution framework is limited and would encourage authorities to align this framework with international standards. We would encourage authorities to assist in the resolution of NPLs. While banks need to engage more proactively in this regard, authorities need to ensure they have a strong oversight role in the development of NPL resolution strategies while streamlining the relevant administrative processes. We agree with staff that a review of CBSM law is a priority in terms of its independence, governance and transparency and would encourage the authorities to begin such a review as a matter of urgency.

Mr. Sylla, Mr. Olhaye and Mr. Ondo Bile submitted the following statement:

We thank Staff for the comprehensive report, and Mr. Fanizza and Mr.Spadafora for their insightful buff statement.

San Marino's fragile banking sector continues to weigh on the economy. While economic growth has remained subdued in 2018, we take positive note of the fact that deposit outflows have subsided in 2018 and that the fiscal deficit has improved. We urge the authorities to press ahead with their reform agenda to adjust the economy while expeditiously restructuring the financial sector as growth prospects over the medium-term remain challenging.

On fiscal policy, we encourage the authorities to pursue an ambitious fiscal adjustment addressing both revenue and expenditure measures to place public debt on a sustainable downward path while building fiscal buffers. We welcome the authorities' new measures contained in the 2019 budget aimed at offsetting the expiration of the one-off measures implemented in 2018 in an effort to further narrow the fiscal deficit. The authorities' plan to introduce further measures during the year to contain potential pressures from CRSM's 2018 financial results, and the envisaged introduction of VAT by 2020, which could help increase economic efficiency, broaden the tax base, and enhance integration and revenue mobilization should yield positive outcomes.

On the financial sector, we welcome the authorities' actions already taken and encourage them to step up their efforts to strengthen the measures that have already been planned aimed at addressing financial sector vulnerabilities notably the measures to increase liquidity management and improve the Asset Quality Ratio (AQR) disclosure process, both of which will be key to restoring the health of the banking system. We encourage the authorities to take further measures to bolster CRSM's reserves, including through aligning the Emergency Liquidity Assistance (ELA) framework to international standards. We also urge them to restrict lending to fully-collateralized loans provided only to solvent banks and supported by credible repayment guidelines. As noted in the staff report, deep restructuring is required to properly address the fundamental problems within the banking system and to increase profitability, address tax credits in the banks' balance sheets, and enhance NPLs resolution process.

On structural reforms, we commend the authorities' commitment to tackle structural impediments to growth, and the noteworthy progress made in improving their score under Doing Business in recent years, although room for improvement remains for several indicators including starting a business and getting electricity. We also take positive note of the recent "Development Law" that has eased the process of hiring nonresidents and that already is yielding positive returns. We encourage the authorities' efforts to deepen their engagement with Italy and the EU to expand domestic companies' opportunities regionally, as well as for the improvement in telecommunication infrastructure, as these are encouraging steps to promote robust growth Furthermore, we expect the recently-established Office for Active Labor Market Policies, pointed out in Mr. Fanizza and Mr. Spadafora's buff statement, to also benefit greatly San Marino's business environment, through enhancing human capital and job creation.

Mr. Trabinski and Mr. Danenov submitted the following statement:

We thank staff for the informative report and Messrs. Fanizza and Spadafora for their insightful buff statement. Economic growth in San Marino is expected to remain subdued. The long-lasting vulnerabilities of the financial sector, low fiscal buffers and weak external position pose a significant risk to the economic outlook and call on for a vigorous policy response aimed at i) restoring banking viability, ii) improving debt sustainability, and iii) tackling structural impediments to growth. As we broadly agree with staff's advice, we offer following points for emphasis.

We encourage the authorities to focus on restructuring the banking sector. We agree with staff that the loss recognition, recapitalization and the NPLs resolution are needed to improve the financial market confidence. The private banks should first try to tap capital from private sources. Only systemically-important and viable banks should benefit from the state support with the responsibility shared with the bank's shareholders and on market terms. We welcome the Asset Quality Review update and the authorities' intention to boost the effectiveness of the Financial Sector Strategy by enhancing the Central Bank of San Marino's (CBSM) supervisory powers and strengthening relations with the Bank of Italy. In this regard we share staff's call for improvement of the CBSM's governance and independence framework.

A comprehensive fiscal strategy is needed to gradually rebuild buffers and achieve growth-friendly fiscal consolidation. In order to reduce fiscal risks, it is important to put public debt on a sustainable path, strengthen debt management capacity and diversify the sovereign financing sources. In this context, we welcome the authorities' plan to replace the single-stage import tax with a VAT in 2020 which will yield additional revenues and improve economic efficiency. We also encourage the authorities to develop and prioritize the pension reform.

We support the authorities' efforts to diversify the economy and expand market access. In order to ensure sustainable and inclusive growth it is important to address structural weaknesses through strengthening the labor supply, improving the business climate and closing the infrastructure gaps. We hope that the established bodies such as the Office for Active Labor

Market Policies and the Economic Development Agency would contribute to that effect.

Mr. Sun and Ms. Cai submitted the following statement:

We thank staff for the concise report and Mr. Fanizza and Mr. Spadafora for the informative buff statement. Facing a number of uncertainties ahead, the authorities are encouraged to take steadfast actions to address the challenges the economy is facing, and strengthen resilience to shocks. We broadly agree with staff's appraisal, and would like to limit our comments as follows.

A comprehensive strategy is crucial for addressing the vulnerabilities in the financial sector. We welcome the completion of the Asset Quality Review (AQR), which is useful in identifying the main areas of concern and in developing appropriate responses. The new legislation to facilitate out-of-court debt restructuring is an encouraging step, and a timely restructuring of the Cassa di Risparmio della Repubblica di San Marino (CRSM) is key to regain the bank's ability to support the real economy. We share staff's view that a coherent strategy and decisive actions are needed to address weaknesses in the banking sector to safeguard financial stability. In this regard, NPL resolution should be advanced and private sources to boost private banks' capital should be encouraged. We also agree that enhancing the central bank's intervention power and tools, as well as reviewing the Central Bank Law, are needed to strengthen financial sector oversight and improve financial safety net.

More needs to be done to ensure public debt sustainability. In the long run, a broader fiscal strategy would be required to increase revenues and keep expenditures in check. On the revenue side, we welcome the authorities' concrete plan for introducing the VAT tax as staff recommended. On the expenditure side, the spending review and the cut of non-mandatory spending are all necessary steps to take. Meanwhile, it is important for the authorities to remain mindful of moral hazards in the bank recapitalization process and limit government support to tackling only systemic risks. Going forward, we encourage the authorities to enhance their public financial management capacity, seeking technical assistance when needed. Where available, fiscal resources should be focused on expenditures and investments that are growth-enhancing.

The authorities are encouraged to further improve the business environment and diversify the economy. We take positive note that a onestop-shop was set up to facilitate a more efficient process for establishing a business while evaluating other measures to reduce red tapes. From the Informational Annex, it is noted that good progress has been made in improving San Marino's data, but various data gaps continue to exist, including in areas such as balance of payments. We encourage the authorities to step up efforts to enhance the quality of data and improve transparency, which in turn would help build investor confidence in the economy.

With these remarks, we wish the authorities every success in their policy endeavors.

The Acting Chair (Mr. Furusawa) noted that San Marino's growth prospects were weighed down by serious banking sector weaknesses. A comprehensive strategy—including banking system restructuring, growth-friendly fiscal consolidation, and structural reforms—was urgently needed to boost competitiveness and bolster growth.

Mr. Just made the following statement:

We fully agree with the reform priorities that the staff has outlined in the staff appraisal.

We were struck by the following sentence in the staff reports: "Recognizing the gravity of the challenges ahead, the authorities continue to discuss how to restore banking system viability and safeguard public finances with local stakeholders."

In paragraph 12 we get a sense of those discussions and the policy response outlined by the authorities to address the significant risks, which does not give much confidence, especially against the background that they have been discussing variations of the same themes for several years now. We will not deny that there has been some progress over the years, but we continue to lack this decisive and multipronged action by the authorities to restore confidence in the banking sector, which is intrinsically linked to the fiscal one. We are also skeptical that the growth impulse coming from Italy will suffice for San Marino to grow out of its problems, and we wonder how long San Marino can continue with this policy of muddling through.

San Marino is still rich in per capita terms but is ultimately a capacity-constrained small state. Often outside parties are required to spur the authorities into action and to overcome policy paralysis. The Fund is the obvious and probably only outside party, and we look forward to the staff's update on the state of play for the program negotiations, which seemed to be already fairly advanced last October.

Mr. Tan made the following statement:

I have a few comments to add, picking up on the banking sector vulnerabilities that were raised in our joint gray statement with Mr. Doornbosch.

For a start, we agree with other chairs on the urgent need to restore banking sector health. With this in mind, we believe time is of essence for San Marino, and we encourage the authorities to do more and to act fast. Ms. Pollard remarked eloquently in her gray statement that any credible reform strategy must begin with a comprehensive package of upfront measures to put the vulnerable banking sector on sound footing. We cannot agree more because as experience has shown, weak banks do not lend and they do not support economic growth, and not dealing with the banking issues in a timely manner would risk making the eventual recovery or resolution efforts more difficult and more expensive. More specifically, on recognizing losses up front and raising fresh capital, we were much interested to hear the staff's response to the technical questions raised by Mr. Saito on the potential sources of external financing and authorities' concerns about burden sharing.

Prior to that, like Ms. Levonian, we believe that private sector solutions should be pursued first to minimize moral hazard and instill market discipline. The use of any public funds should be a last resort and only for viable systemically important banks. Bank failures are part and parcel of risk-taking in a competitive environment. Policymakers had little choice but to use public funds to rescue failing financial institutions in the last crisis. That was the so-called too-big-to-fail problem. We will call on the staff to work with the authorities to not let the existing vulnerabilities escalate into a too-late-to-save problem given San Marino's fiscal constraints.

On reducing NPLs and high operating costs, banks can never have enough capital if there are material longstanding flaws in their risk management practices and inefficiencies in their business model. We agree fully with Mr. Castets and Mr. Sigurgeirsson on prioritizing NPL and cost reduction. Poor asset quality and profitability will lead directly to liquidity insolvency, so addressing these intertwined issues fundamentally will, one, facilitate capital accretion, which is clearly in short supply; two, help rebuild confidence in the banking system; and three, increase banks' ability to raise new equity from the market.

On the emergency liquidity assistance (ELA) framework, it will be useful to distinguish between providing solvency support to absorb losses and serving as lender of last resort to provide temporary, fully secure liquidity to the illiquid viable banks. We will encourage that the ELA remain as a temporary stabilization tool and to link any liquidity and solvency support to other more permanent corrective measures.

Lastly, on strengthening financial sector oversight, the ability to supervise and the will to act have emerged as a key issue from the last financial crisis, so a clear and unambiguous mandate, operational independence, coupled with accountability will be critical to empower the Central Bank of San Marino to implement the necessary reforms to take timely and effective actions and follow through the supervisory process to its conclusion.

Mr. Alkhareif made the following statement:

The country faces key challenges, and the outlook is subdued. In this context, we welcome the indication that the authorities will implement a comprehensive reform agenda to address the key challenges in the banking system and the fiscal side. In this context, we agree with the staff's recommendation to simultaneously restore banking viability and improve credit supply, safeguard public finances, and promote sustainable growth. At the same time, we see merit in using proper prioritization and sequencing of the reforms. Perhaps starting with the stabilization first and then addressing the structural issues could be appropriate.

I just want to reflect on the difference of views between the staff and Mr. Fanizza on the debt implications for the banking system. In paragraph No. 8, the staff highlighted that the public debt is currently at 27 percent of GDP, and if the banking system liabilities were to be taken care of from the public side, that will jump to 77 percent of GDP. That is a significant number, and we would appreciate further elaboration. What is the baseline scenario in the case of government intervention? How much debt will be realized? With these comments, we wish the authorities continued success.

Mr. Sigurgeirsson made the following statement:

I have issued a gray statement, but I also come from a very small country, having faced similar problems. I would like to add a few words.

It is clear that San Marino is challenged by the deep-rooted banking problems, and we fully agree with the staff that banking system restructuring is urgently needed, and not the least, advancing NPL resolution should also be prioritized.

The banks' capital needs should be promptly addressed and liquidity position strengthened. The recapitalization needs to be sizeable, and therefore it is important that the state be guided by fiscal sustainability considerations, and bail-in measures should not be ruled out.

I feel like I have seen this movie before. The problem will not work itself out automatically, and unfortunately the authorities are faced with unpleasant choices—on the one hand, to take harsh measures up front with the aim of ring-fencing public finances, and on the other, facing slow deterioration where at the end the government will end up footing the bill. It is welcome to note that the Central Bank of San Marino highlights the urgency of getting improved powers and tools to announce the banks' resolution framework to effectively deal with the failing supervised entities.

Mr. Saito made the following statement:

As we have issued a gray statement, we would like to offer one comment and question. We have concerns that the banking system remains fragile with low liquidity, poor asset quality, and high NPLs. We encourage the authorities to address their banking system vulnerabilities and deepen banking system restructuring. We agree with Ms. Pollard and Ms. Svenstrup that the collapse of the offshore banking model caused deep-rooted legacy banking problems. In this context, we would like to hear the staff's view on what kind of business model for banks or what financial system structure is needed or recommended to sustain the economy.

The staff representative from the European Department (Mr. Klein), in response to questions and comments from Executive Directors, made the following statement:[2]

I thank Directors for their insightful comments and technical questions, which we have addressed in writing. My remarks will focus on some of the broader issues that were raised by Directors, particularly the external financing options, the government interest in a Fund-supported program, and burden-sharing. At the end, I will refer to some of the questions that were raised in the Board.

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[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Starting with financing sources and Fund engagement, the authorities intend to seek external financing to repair the banking system but have yet to reach full consensus on the way forward. They considered several financing options, including bilateral loans from foreign governments and banks, FDI in the banking system, and targeted access to the bond market. A Fund-supported program is also being considered as an important option, as it could provide structure to the ambitious reform agenda and technical expertise in areas where capacity is highly limited. A Fund-supported program could also catalyze lending by other external sources and support efforts to diversify financing.

The staff view external financing accompanied by policy adjustment as critical to overcome the low liquidity in the system, which has reached vulnerable levels. External financing and policy adjustment will also support the buildup of the central bank liquidity buffers and its ability to safeguard financial stability. Without external support and decisive reforms, financial stability risks will remain high.

As the authorities are still weighing their options, the staff will maintain close engagement, provide technical support as needed, advise on policies to support growth and stability, and continue to assist them with developing contingency plans given the elevated risks facing the banking system.

Discussions on the financial sector strategy, including bank recapitalization options will continue in the near future, including during the upcoming Spring Meetings.

As for burden-sharing, the authorities recognize the risks related to a full bailout of the banking system, yet they see bail-in as a breach of pre-election commitment, and thus it remains a contentious issue among the coalition partners. They also expressed concern that this will undermine confidence and potentially destabilize the banking system, and thus in past bank resolution cases, they chose to impose losses only on equity holders while protecting all other creditors, including subordinated debt holders.

Regarding the size of the potential contribution from burden-sharing, ultimately it will be guided by fiscal and debt sustainability considerations, including financing capacity and the feasible fiscal adjustment, as well as the scope of the banking system recapitalization. The staff's analysis suggests that the public debt of around 50 percent of GDP is a prudent medium-term fiscal anchor as it could keep financing manageable. Combined with primary fiscal surplus of about 2.5 percent of GDP over the next years, which the staff considers feasible, it would also allow for a gradual buildup of government deposits at the central bank to a prudent level of at least two months of spending.

This would imply that public sector contribution for bank recapitalization should be no more than 30 percent of GDP, while the remaining part would have to come from private sources, including raising private capital, retaining profits, and burden-sharing.

With regard to the questions that were raised at the outset of the meeting, there is a difference between the official public debt as reported by the authorities and what we considered as the implicit public debt, which takes into account the government commitments to the banking system. These commitments includes the tax credits, which we believe need to be accounted for as fiscal liability because they were created to cover the asset liability banks following the absorption of failed banks, and the legacy losses of Cassa di Risparmio della Repubblica di San Marino (CRSM), the state-owned bank, which the government committed to cover, and spread it over a period of 25 years. The current approach of the government is a gradual recapitalization of the bank, so under the baseline scenario, the official public debt would increase gradually over time due to this repeated recapitalization of the state-owned bank. We recommend an upfront recapitalization, and therefore we also take into account the whole amount of those fiscal liabilities in our calculation for the implicit public debt. If we consider all these liabilities, public debt will rise to an unsustainable level of 77 percent of GDP. This is unsustainable for San Marino because San Marino does not have market access, domestic financing options are very limited, and debt management capacity is weak. Moreover, at that level, interest payment on the debt will increase to 30 percent of total revenue, which is unsustainable and poses significant risks. Therefore, we propose burden-sharing and limiting government contribution to the banking system.

As for the question on banks' business model, over recent years, the assets in the banking system have declined significantly, and while assets have declined, the costs have not declined as much, and as a result, the banking system is highly inefficient. There are 47 branches in a very small place, imposing significant costs. Some banks have submitted industrial plans that include some interest in more risky projects, including virtual currency and wealth management, including abroad. Our view is that at the current stage, where supervision is relatively weak, the banking system needs to focus on the traditional banking activities and consolidate with a focus on cost reduction.

Mr. Fanizza made the following concluding statement:

On behalf of my San Marino authorities, I thank Directors for their insightful comments, which I will report to the authorities. I would also like to reiterate my authorities' appreciation for the candid and cooperative discussions they have had with the staff. They appreciate the recommendations, the fact that policy advice was well tailored to the country's circumstances, and also the technical assistance they received. They are very happy with the staff.

Let me make some comments on San Marino. There is good news in the sense that the manufacturing activity has been much stronger than one expected. Nevertheless, the country faces major challenges. That is clear. Mainly these challenges are linked to longstanding problems in the banking sector and also the impact of these problems on the fiscal position, as Mr. Klein explained. These problems are mainly related to the operation of one bank, which is publicly owned, CRSM. That is the crux of the problem, which does not mean that there are no problems elsewhere, but that is a big potato.

The authorities fully agree that strengthening bank liquidity—both the liquidity and the capital position of the banks—is the top priority and they broadly agree on how to do it. They have no doubts that without fixing the banking system, the country's growth prospects will not improve, and the fiscal position will not be sustained. That is clear. There is full understanding of the importance of the issues and the stakes which are in front of them. Resolving the problems of banking sector, is a necessary condition but not sufficient. Other things need to be done, particularly structural reform on the fiscal side, and there the most important is the introduction of the VAT regime in the country. That is the broad message that the authorities want to convey, and which they agree with the staff, and over the last year, the authorities have worked closely with the staff to develop a consistent reform strategy for the financial sector, which basically means the banking sector. This strategy includes reducing operational costs, which are particularly high, a better bank resolution framework, new tools for the regulators of the central bank. There has been some progress, but country-specific characteristics represent important constraints for the authorities' capacity to address the issues.

First, the location of the country as a small enclave in Italy with virtually no borders, means that the country is particularly sensitive to capital flows. It is very easy to move money away from the country, so it is also easy to deposit money in a bank which is 15 kilometers away in Italy. In San Marino, that is a major concern because any decision to act on the banking system could have an impact on financial stability because it could trigger outflows from the system. One needs to be very careful.

Second, the country is small with only 32,000 people, and it is difficult to take policy action without building broad consensus. Those are difficult things. They are not unique to San Marino because many countries face these constraints, but San Marino faces this to an extent which is much bigger and important. This is why the authorities have concerns about the staff's suggestion to apply burden sharing. In fact, they agreed in principle that this should be done, but they acknowledge that it is difficult in their particular situation. They are thinking about it, and they would work with the authorities to find ways to make progress. Recent developments in Italy, in particular the EU court decision that federal bail-in for two Italian banks was not justified, created a justification to argue that when one does a bail in without being too careful, this could create big problems, and there were actually two banks that were very close to San Marino. But that is on the side.

More in general, the authorities, while acknowledging the difficulty of the situation, remain confident that the economic prospects will receive a boost from the structural reforms that they are doing. They also believe that the possibility of an association agreement with the European Union would facilitate business activity in the country, and they hope to sign a memorandum of understanding with Bank of Italy on how to collaborate and conduct business together. They believe that these are bright sides and bright things that could help the country.

In conclusion, I thank Mr. Klein and his team for their hard work, patience, and their excellent engagement with the authorities. Thank you very much to everybody.

The Acting Chair (Mr. Furusawa) noted that the Republic of San Marino is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They noted that deep-rooted weaknesses in the banking system have dampened credit conditions, undermined economic activity, and are now threatening financial stability and fiscal sustainability. Directors emphasized that upfront recapitalization and restructuring of the banking sector, growth-friendly fiscal consolidation, and structural reforms are urgently needed to shift the economy to a sustainable growth path.

Directors stressed the importance of safeguarding central bank liquidity buffers, including by aligning the emergency liquidity assistance framework with international best practice and restricting the central bank's budget financing to only exceptional needs and on a temporary basis. Developing a well-crafted communication strategy is also crucial to effectively respond to a potential resurgence in liquidity pressures and protect the payment system.

Directors underscored that it is important to address banking system fragilities and restore its viability. They underlined the need for a deep restructuring, including through significant cost reduction and durable resolution of the high level of non-performing loans, enhancement of bank liquidity positions, and a recapitalization that relies on a mix of public support and private contributions. Converting tax credits into government bonds is also essential to restore banking system viability. Directors stressed the importance of enhancing the central bank's powers and strengthening its capacity to oversee the banking system and called for reviewing the central bank law to increase its accountability, governance, and independence. They welcomed the progress in strengthening the framework for anti-money laundering and combating financing of terrorism while noting that further efforts are needed to contain financial integrity risks.

Directors stressed the need to contain government's contribution to banks' recapitalization and adopt a credible fiscal consolidation strategy, which relies on indirect tax and pension reforms, rationalization of tax rebates, and improvement of spending efficiency. They noted that successful adoption of the VAT will play an important role in broadening the tax base and mobilizing revenues. Directors urged the authorities to strengthen debt management capacity and diversify financing options to reduce fiscal risks.

Directors stressed that addressing structural impediments and expanding market access is important to promote higher growth. They welcomed the recent measures to relax the hiring of nonresidents and underscored that further efforts to enhance the business environment, improve labor market flexibility, and close infrastructure gaps would boost San

Marino’s growth potential. Directors supported the authorities’ efforts to increase economic integration with the European Union.

Directors welcomed the progress made in data provision and encouraged the authorities to further improve the frequency, coverage, and reporting of relevant statistics.

It is expected that the next Article IV consultation with the Republic of San Marino will be held on the standard 12-month cycle.

APPROVAL: April 24, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook/Risks

1. The weakening in the demand from Italy, which accounts for 86 percent of the island's exports and 61 percent of the tourists, is likely to contribute to the slowdown in 2019. In this regard, we would welcome staff's assessment of the impact of the technical recession by end 2018 in Italy on San Marino's growth and fiscal policy.

- The technical recession in Italy began to affect the Sammarinese economy in the last quarter of 2018, when employment growth, which was particularly strong in the first half of the year, slowed down and unemployment started to rise. These trends are likely to continue in 2019, and coupled with an expected slowdown in export—as Italy is the economy's main trading partner—will result in lower growth compared to 2018. Considering the less favorable external environment and lingering weaknesses in the domestic banking system, staff's medium-term growth projections have been revised down significantly compared to those in the last Article IV staff report.
- With the expected economic slowdown, fiscal policy will need to be managed prudently, especially in light of further possible headwinds from the banking sector. The limited fiscal buffers undermine the government ability to effectively support demand in case of a sharp downturn.

Fiscal Policy

2. While we saw some benefits from adopting the VAT, such as the wider tax base, we also note the staff's assessment on implementation challenges, such as tax administration capacity. Do staff think that two IMF technical assistance missions have sufficiently addressed these issues and the authorities will be able to smoothly implement the VAT?

- The technical assistance missions have provided useful policy advice and have been much appreciated by the authorities. The challenges related to a smooth implementation of the VAT are due to the ambitious deadline that the authorities are committed to. The tax office is small, and the VAT will require several changes compared to the current system in place with the Monofase. Staff need to be trained for such a transition and IT systems will need to be upgraded, suggesting that more time could reduce the implementation risks.

Financial Sector

3. We agree with the staff's view that the CBSM reserves should be brought to adequate levels, including by aligning the ELA framework with best practice and restricting the CBSM budget financing to only exceptional needs and on a temporary basis. Could staff share the modalities of the current ELA framework?

- The current ELA framework allows the CBSM to provide liquidity to supervised banks with adequate guarantees. Banks can borrow from the CBSM through repo transactions or through an overdraft facility using their current accounts at the CBSM. As an internal process, the CBSM is supposed to make decisions based on solvency, profitability and liquidity of the bank's requesting ELA as well as adequacy of collateral to be used. In practice, however, the CBSM has provided ELA without sufficient assurance of repayments and accepted illiquid securities as collateral.

4. Improving efficiency and profitability as well as advancing NPL resolution are important to support financial intermediation. Could staff elaborate on the background of high NPLs? Also, in what kind of sectors have NPLs been accumulated?

- Substantial credit risk portfolios were accumulated during the period preceding the global financial crisis, where banks engaged in aggressive lending, using imported deposits to fund the growth, but without the proper credit risk controls. Following the crisis, the credit risks materialized and the NPL ratio increased rapidly, growing to around 55 percent of total loans in 2018. A very large portfolio of foreign credit risk (€2.2bn, or 145 percent of GDP), which was mainly owned by Sammarinese banks and the majority of which was recently disposed of, was estimated in the 2016 AQR to have an NPL ratio of 97 percent. Furthermore, unwillingness of banks to resolve NPLs due to their weak capital positions to absorb losses, along with several legal and tax impediments for NPL resolution, also contributed to continued elevated NPL levels in recent years.
- A sectoral breakdown of net NPLs is shown in a chart in page 6 of the Staff Report. The services sector accounts for the largest share of 42.8 percent of total net NPLs, followed by the household sector (19 percent) and the industry sector (12 percent).

5. We take note of the disagreement between staff and authorities regarding the role of burden sharing in addressing capital shortfalls. As we stressed in the past, we underscore the importance of ensuring that shareholders and subordinated debt holders contribute to loss absorption before injecting fresh capital. However, we acknowledge that, in some cases, this may create material negative side effects that make this option unfeasible. Could staff offer an explanation on why the

authorities are so worried about burden sharing? Could staff provide an estimate of the potential contribution from burden sharing to the recapitalization process?

- Staff will respond to these questions during the Board meeting.

6. Staff note that higher capital levels will be required under the application of the EU standards, which are due to be transposed in 2019 with a yet-to-be determined transition period. Can staff discuss when in 2019 they expect such standards to begin and whether they foresee issues with compliance?

- The San Marino authorities have transposed CRD IV and CRR at end-2018 into primary legislation and plan to issue secondary (delegated) regulations for implementation in 2019, but there will be a long transition period into achieving full compliance. Although the transition period has yet to be agreed between the San Marino authorities and the EU, the authorities had indicated that they are hoping for at least several years.

Structural reforms and Economic integration

7. Further, the authorities argued that "the conclusion of the association agreement with the EU and signing of Memorandum of Understanding with the Bank of Italy could have significant benefits." Could staff provide additional details on the near-term feasibility and potential impacts of these two actions?

- The authorities attach significant benefits to the association agreement with the EU as it would simplify procedures for domestic firms in operating in the EU market, helping to reduce San Marino's high reliance on Italy's economy. It would potentially also grant financial institutions passporting rights and allow them access the broader EU market. The authorities submitted their proposal to the European Commission and hope to conclude the negotiations by end-2019.
- Regarding the MoU with the BoI, discussions mainly focused on technical assistance, particularly between the two central banks on issues such as bank resolution tools, NPL reduction, connection between central credit registers, and path towards implementation of Basel III. The timeline for concluding these discussions is highly uncertain.

Fund engagement and possible financing options

8. ***In this regard, we note that the authorities underline that domestic resources for banking system repair are insufficient and noted their intention to seek external financing. Could staff elaborate on the potential financing sources?***

9. ***In this context, the authorities recognize that domestic resources for banking system repair are insufficient and note their intention to seek external financing. Could staff comment on where this external financing might come from?***

10. ***After the progress made over last year in enhancing data provision and in completing the AQR, those information gaps seem to have been bridged. Could staff elaborate on the possibility of a Fund-supported program to address San Marino's financing needs?***

11. ***We would appreciate any updates from staff on discussions on a Fund-supported program for San Marino, per press reports late last year. In the absence of an agreement on a program or other bilateral assistance, we would welcome more context on contingency plans to support the banking sector and broader reform agenda.***

- Staff will respond to these questions during the Board meeting.