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San Marino: 2006 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for San Marino

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2006 Article IV consultation with San Marino, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on December 11, 2006, with the officials of San Marino on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on February 7, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its February 23, 2007 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for San Marino.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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REPUBLIC OF SAN MARINO

Staff Report for the 2006 Article IV Consultation

Prepared by Staff Representatives for the 2006 Consultation with the Republic of San Marino

Approved by Alessandro Leipold and Anthony Boote

February 7, 2007

EXECUTIVE SUMMARY

Background: San Marino is reinventing itself in response to global competition**.** A slew of reforms has been initiated, which, combined with stronger growth in neighboring Italy and the euro area, have improved macroeconomic prospects. Growth has rebounded. Public spending has been contained, but the budget surplus has been eroded mainly due to initiatives to preserve tax advantages. While the financial sector is sound, it is in transition as institutions adapt to changes in taxes and regulations. Supervision is being strengthened.

Challenges: These are two-fold: to manage the transition toward an economy based on the high value-added service sectors, including the financial sector, and to counter fiscal pressures arising from an ageing population, mobile factors of production, generous entitlements, and the need to keep tax rates competitively low. The small size of the territory and population and its land-locked location within Italy pose constraints.

Staff views: Already-enacted reforms must now be implemented. In particular, the Central Bank of San Marino (CBSM) should be allowed room to implement the new regulations expeditiously, and exercise greater oversight of financial institutions as they venture into new lines of businesses. Public finances should be shored up through measures to broaden the tax base, improve public enterprise balances, and further curtail current spending. Additional pension reforms may become necessary, and a fiscal rule could be considered. Plans to streamline public administration and introduce a mandatory defined-contributions second pillar pension system should proceed. Reforms are also necessary to boost the supply of high-skilled labor to support the growing service sectors. Finally, statistics must be improved to facilitate policy formulation.

Authorities' views: There is wide recognition that reforms need to continue, and that the future of the economy lies in the service sectors. The authorities are cognizant of the risks inherent in a financial sector in transition, and have taken measures to strengthen oversight. Increased investment, modernization of laws, streamlining of procedures, and a reduction of the tax burden should strengthen growth prospects. The staff's fiscal policy recommendations were well received, although a fiscal rule might need to await further improvements in budget accounting. The authorities believe that labor market reforms will not be easy to implement due to resistance from entrenched interests and geographical constraints.

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I. Background

1. **San Marino, a small country embedded within Italy, is inextricably linked to its large neighbor**. The countries are bound in a monetary and customs union. Porous borders facilitate trade and factor mobility, with much of San Marino's exports destined toward Italy, and Italian commuters representing a quarter of its labor force. Well diversified for its size, San Marino relies principally on its manufacturing and, increasingly, financial sector, for growth. The former is supported by Italian manufacturers benefiting from the lower costs and tax advantages of San Marino. The latter has flourished due to the inflow of Italian funds into the banking system in response to tax advantages, and bank secrecy laws.[1]

2. **Recently, San Marino has begun to reinvent itself in response to global competition.** It has come a long way since the early part of this decade when growth was sputtering, public finances were precarious, and the economy was mired in old-fashioned modus operandi. A slew of ambitious reforms have been initiated (text table). These, together with a pick up in growth in Italy and improving competitiveness, have bolstered macroeconomic prospects (Figure 1). While the heyday of double-digit growth of the 1990s is over, growth has rebounded to a robust 5 percent. A declining unemployment rate and sound employment growth suggest that strong growth continued in 2006.

San Marino: Contribution to Growth, 2000–05
(In percentage points, unless noted otherwise)

	2000	2001	2002	2003	2004	2005
Real GDP growth (Annual percentage change)	2.2	5.5	0.3	3.9	4.6	5.0
Final domestic demand	5.7	7.0	3.9	2.3	0.5	...
Final consumption	1.0	-0.4	-0.7	0.3	0.8	...
Private consumption 1/	...	...	...	3.5	-1.5	...
Public consumption 1/	...	...	...	-3.2	2.3	...
Gross capital formation	4.7	7.3	4.6	2.0	-0.3	...
Gross private capital formation 1/	...	...	...	0.0	-0.8	...
Gross public capital formation 1/	...	...	...	2.0	0.5	...
Net exports	-3.5	-1.4	-3.6	1.6	4.1	...
Exports	0.4	1.2	-6.7	6.5	17.5	...
Imports	-3.9	-2.7	3.1	-4.9	-13.4	...

Source: Sammarinese authorities.

1/ Staff estimates based on public finance data produced according to GFS Manual, 2001.

3. **While the public accounts are in surplus, they deteriorated sharply in 2006** (Figure 2). As growth picked up and financial sector profitability stabilized, the budget deficits of yesteryears were reversed, public debt contained, and reserves accumulated. The authorities improved revenue collection through tax administration reforms, and controlled current spending by reining in healthcare costs and fending off steep public sector pay increases. Nevertheless, revenue losses due to corporate tax cuts (from 24 to 19 percent

[1] San Marino acts as an offshore Italian financial center offering a broader range of services than banks in neighboring Italian regions. It is a member of the MONEYVAL Committee of the Council of Europe, a regional body committed to mutual evaluations in anti-money laundering. It is not on any offshore financial center (OFC) list.

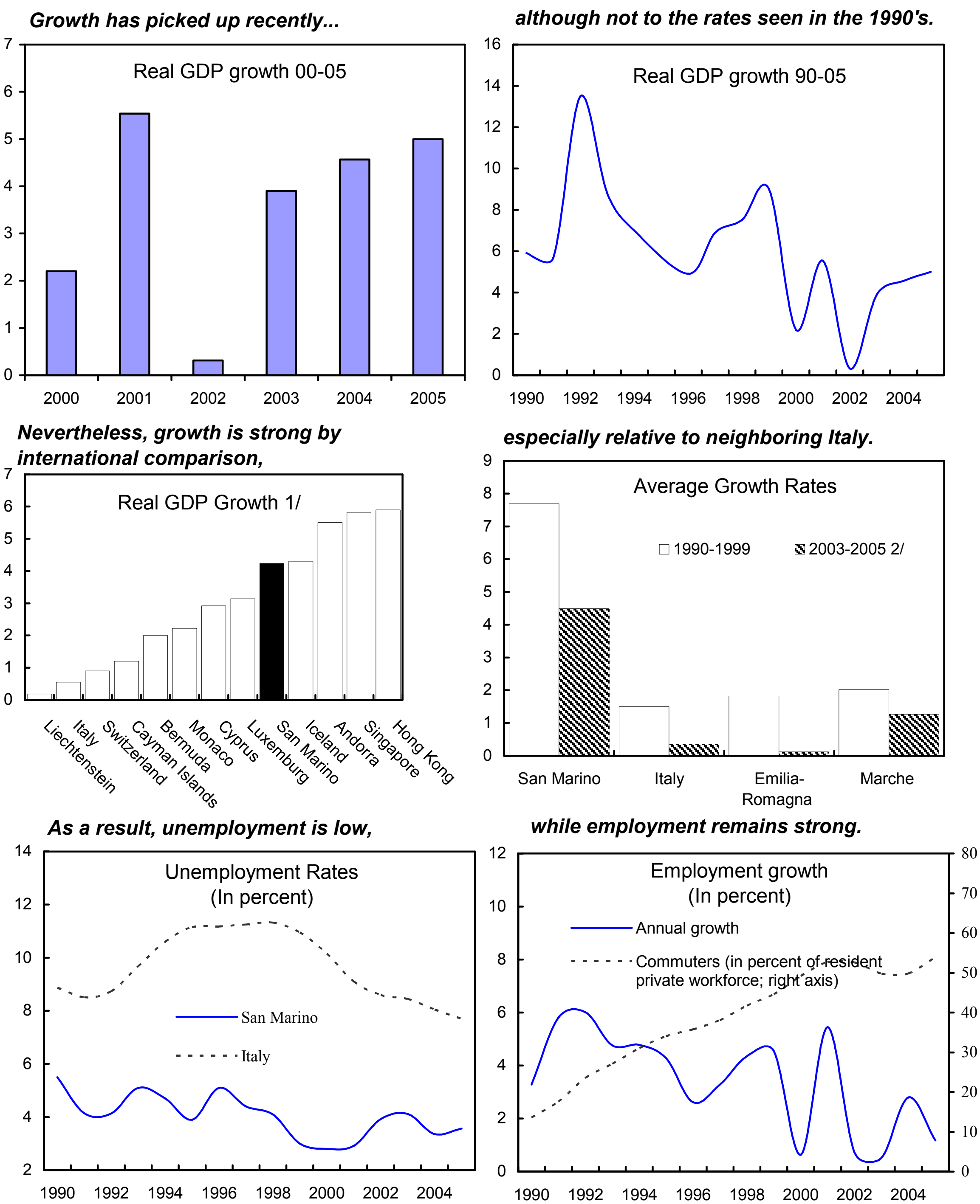
in 2005), steadily deteriorating balances of public enterprises[2], and election-related spending overruns, have reduced the surplus considerably in 2006. An ambitious pension reform, implemented in 2006, has yet to affect the fiscal outcome.

San Marino: Implementation of Fund Policy Recommendations

Policy Area	Fund Recommendations	Implementation
Public finance	Maintain budget surplus, improve tax administration, reform generous entitlements programs.	Consolidated government budget in surplus during 2003–06, although the surplus is expected to decline in 2006–07.
		Tax administration has improved. Key changes: Responsibility of collection of arrears shifted to the CBSM; backlog of import taxes settled through a one-time lump-sum payment; self-settlement system introduced.
		First pillar pay-as-you-go (PAYG) system reformed (Box 1). Plans to introduce a defined contributions second pillar pension system in two stages starting in 2007.
		Health care costs contained through better management practices and by reducing coverage and access. Plans to introduce copayments and generics.
Labor market and business climate	Eliminate remaining restrictions on nonresident workers, allow fixed term contracts for Sammarinese workers, resist tax exemptions, reduce bureaucracy.	New labor law introduces training for young graduates, a wider range of employment contracts, and streamlines work authorization procedures for commuters. Budget incentives for active labor market policies.
		Corporate tax rates lowered. New exemptions introduced. Faster resolution of tax liabilities backlog. Simpler procedures for tax payments.
		A new corporate law enacted in 2006 streamlines procedures for the creation of companies.
Financial sector	Upgrade legislation and improve supervision; increase frequency of on-site supervision; transfer licensing rights to independent supervisory body.	CBSM empowered with supervision, licensing (with government involvement) and extraordinary administration. Firewalls built between Board and supervisory arm of the CBSM to prevent regulatory forbearance. In-depth off-site and on-site supervision initiated. Additional supervisors hired, cross-border cooperation improved, and training of supervisors ongoing. More detailed reporting requirements by banks being initiated.
		New financial sector law enacted in 2005 to modernize rules and regulations and enable new lines of financial sector businesses to operate. Implementing regulations being introduced.
		AML/CFT provisions have been brought further in line with international standards.
Statistics	Further improve statistics.	Fiscal accounts produced according to Government Finance Statistics (GFS) Manual 2001 for 2002-05; IFS country page initiated; quarterly reports of monetary and financial sector indicators provided; business production index launched (Appendix II).
		Plans to participate in General Data Dissemination System (GDDS). Plans to compile a business sentiment index in 2007.

[2] The consolidated government accounts include the balances of the central administration, social security fund, and public enterprises.

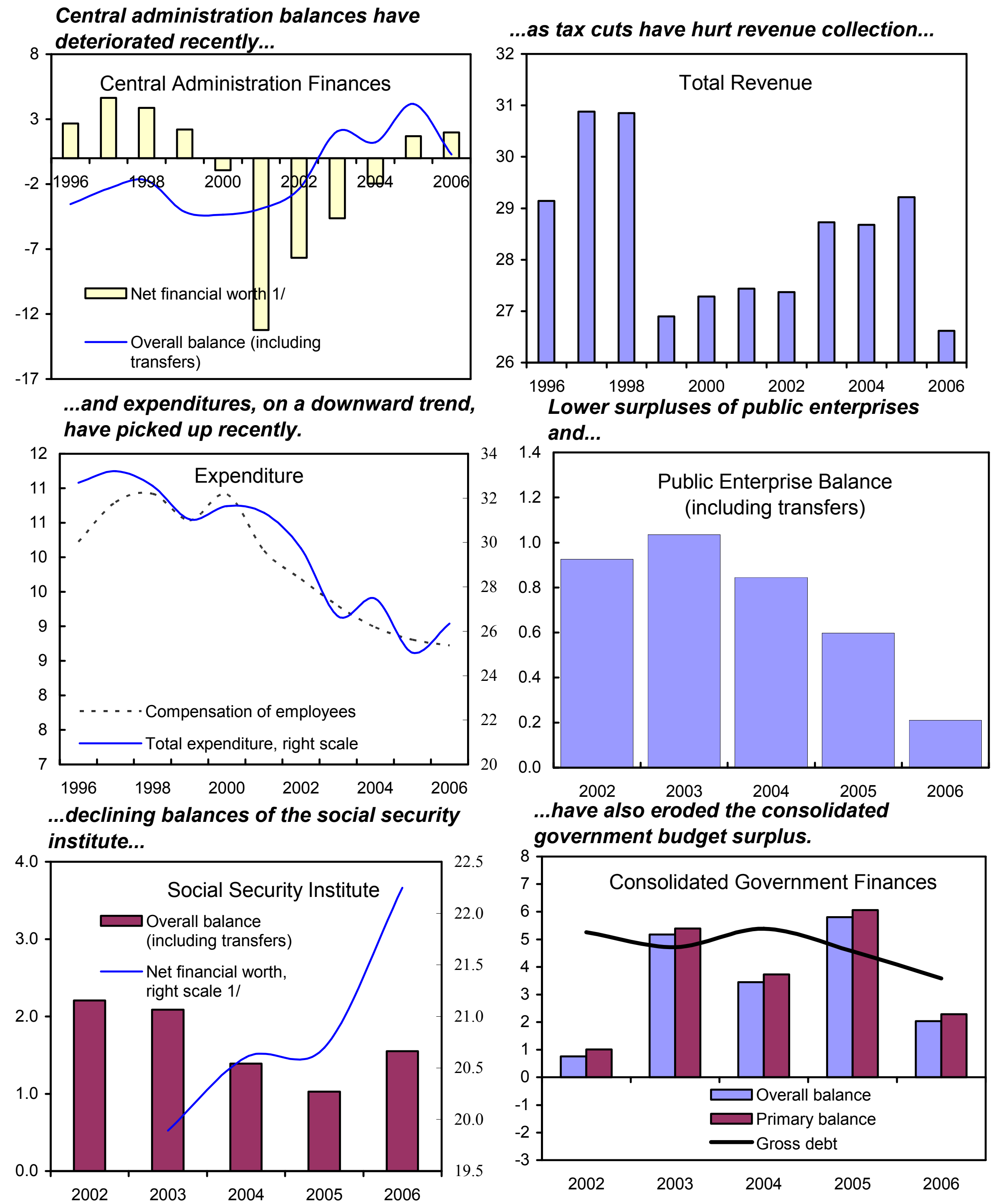
Figure 1. San Marino: Output Developments



Source: United Nations, Sammarinese authorities; ISTAT and Fund staff estimates. For San Marino and the Italian regions data are ESA79 until 1995 and ESA95 thereafter. For San Marino, old and new data do not overlap.

1/ Average for 2003–04.
2/ Emilia-Romagna and Marche are administrative regions of Northern Italy surrounding San Marino. Growth data for these two regions refer to 2003–04.

Figure 2. San Marino: Public Finances (1996–2006)
(in percent of GDP)



Source: Sammarinese authorities and Fund staff calculations for 2006.

1/ Based on the *Government Finance Statistics Manual 2001* .

4. **The financial sector appears to be in good shape:** profitable, liquid and well capitalized (Figure 3, Tables 4–5)[3]. Always a significant contributor to budget revenues, it has become an increasingly important contributor to growth, and there is a general recognition that the further development of this sector will be vital for the future of the economy. Deposits have surged, reflecting a stronger domestic and Italian economy, and the return of funds which fled in response to the 2002 Italian tax amnesty. Currently, the sector is bracing for the full impact of the EU withholding tax[4] which has not hurt competitiveness at the current tax rates. Profit growth has remained subdued due to heightened competition in an increasingly crowded field, leading to greater risk-taking, as evident in a sharp increase in lending to the nonfinancial private sector, mainly corporations, to meet their investment needs. Nevertheless, the number of bank failures has been limited. In 2006, for the first time in Sammarinese history, two small financial institutions were placed under CBSM administration following on-site inspections of their books. One was found to have negative capital due to bad loans and improper oversight, and required liquidity support. The other operated an illegal mutual funds business, and was saddled with governance problems. These cases did not have systemic effects as deposits shifted to other banks, and Sammarinese banks remain more efficient and better capitalized than most of their comparators, with fewer nonperforming loans (Table 5).

5. **The financial sector is undergoing a quiet revolution**. Supervisory powers have now been transferred from the government to the CBSM, which is in the midst of implementing a broad range of initiatives to modernize the sector, facilitate new lines of business and attract a broader clientele, while preserving its soundness and good standing. In-depth off-site and on-site supervision of financial institutions have been initiated, and are beginning to bear fruit as evident in the resolution of difficulties faced by the two problem institutions with no untoward repercussions. Supervisory resources have been increased and supervisors are keeping a close eye on the internal controls and management of financial institutions.

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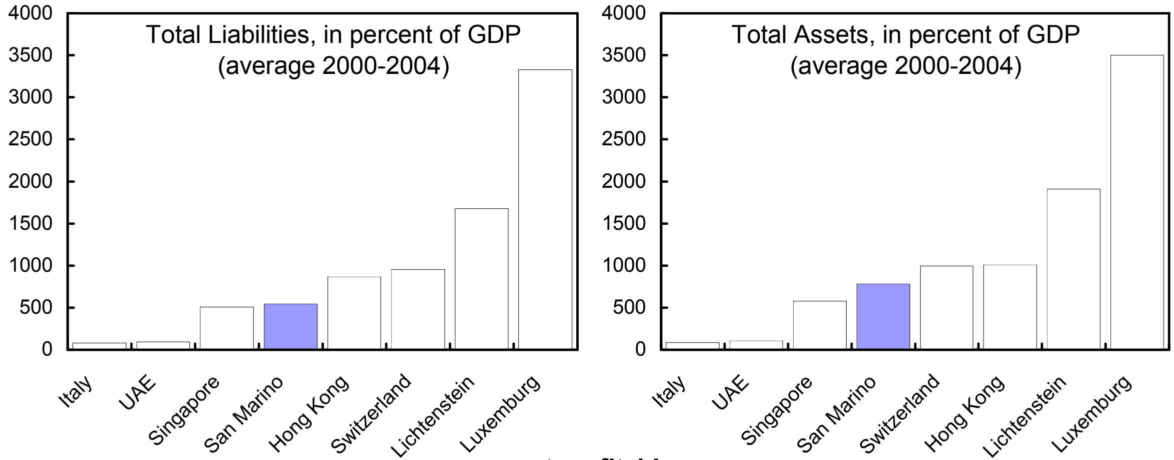
[3] The financial system is dominated by four large "historic" banks and remains concentrated. Nonresident deposits—mostly from Italy—represent about half the banking system liabilities, and the main activity of the financial sector is to place these funds in low-yield/low-risk interbank loans and government securities. The nonbank financial institutions offer fund management, private banking services, and real-estate related financial products.

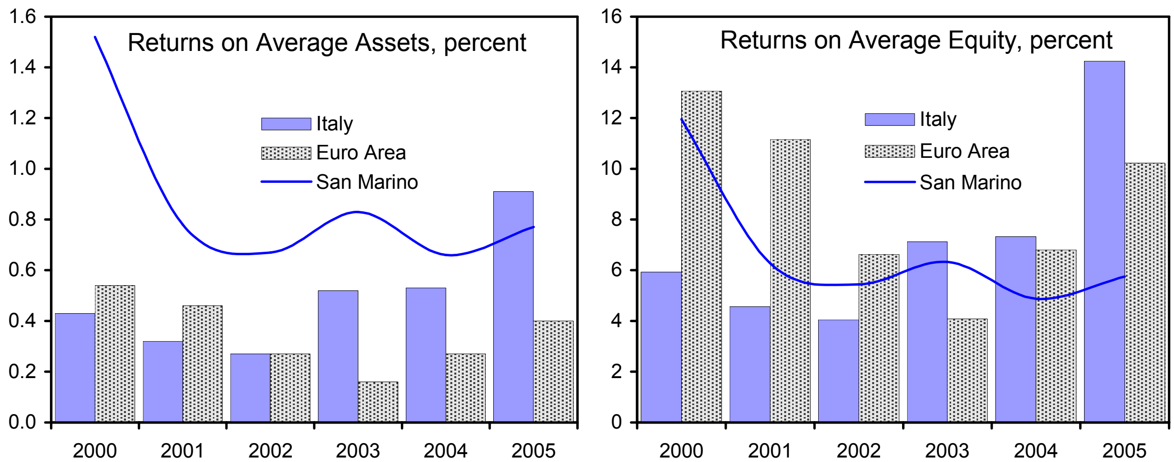
[4] The EU withholding tax, introduced on July 1, 2005, applies to nonresident deposits and bonds at a 15 percent rate for the first 3 years, 20 percent for the subsequent 3 years, and 35 percent thereafter.

Figure 3. San Marino: Financial Sector

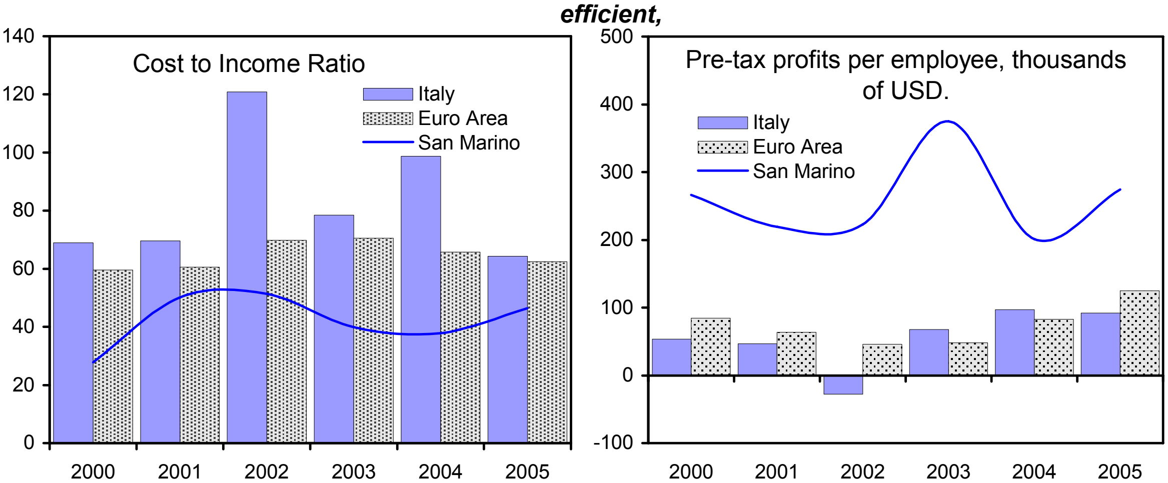
The financial sector is small by international comparison...



yet profitable...

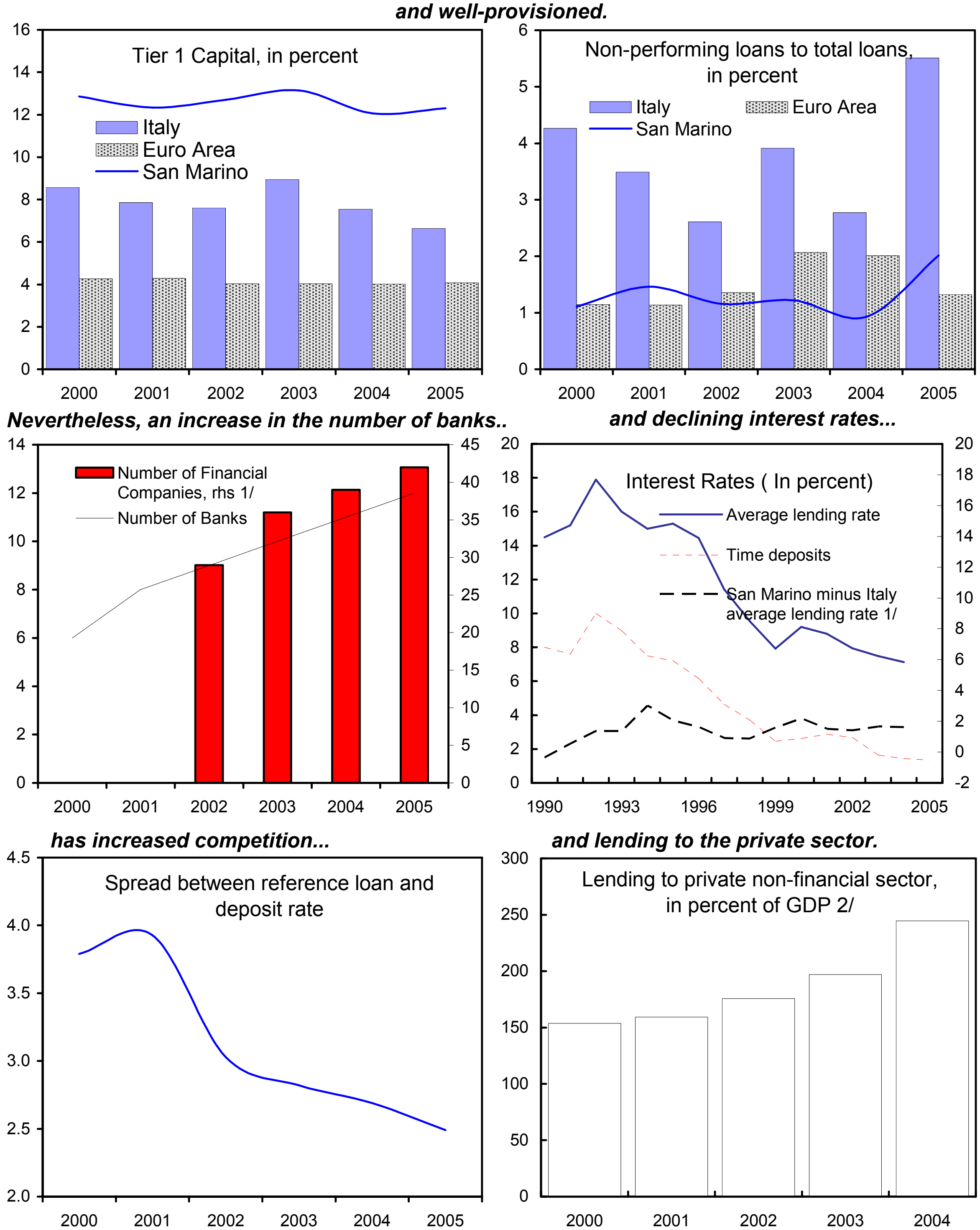


efficient,



Source: Bankscope, Central Bank of San Marino.

Figure 3. San Marino: Financial Sector
(continued)



Source: Central Bank of San Marino, IFS, Bankscope, Sammarinese authorities, Bank of Italy.

1/ Financial Companies extend credit and provide investment services (including security dealing)
2/ Claims on other resident sectors (see Table 4 for sectoral breakdown).

6. **Reforms have been implemented to further improve the economy's competitiveness and broaden the sources of growth**. Several useful steps have been taken to improve labor market flexibility, simplify procedures for hiring non-residents, and enhance productivity by providing fiscal incentives for training. Wage growth has remained subdued, not least due to the efforts to contain public sector wages. Enterprises in the manufacturing sector have started relocating to low-cost countries and Italy, to remain competitive and avoid cumbersome customs procedures for trade with the euro area. A recently enacted business-friendly corporate law seeks to improve governance and the investment climate by clarifying various rules of operation in one comprehensive document. The new financial sector regulations seek to do the same in the financial sector. Lower tax rates, greater clarity in tax liabilities through double taxation agreements with countries, and further simplification of tax payment processes have improved the investment climate and lowered the cost of doing business. All of this has improved competitiveness, especially with respect to the neighboring regions of Italy which account for the bulk of Sammarinese exports (Figure 4).[5]

II. Risks and Challenges

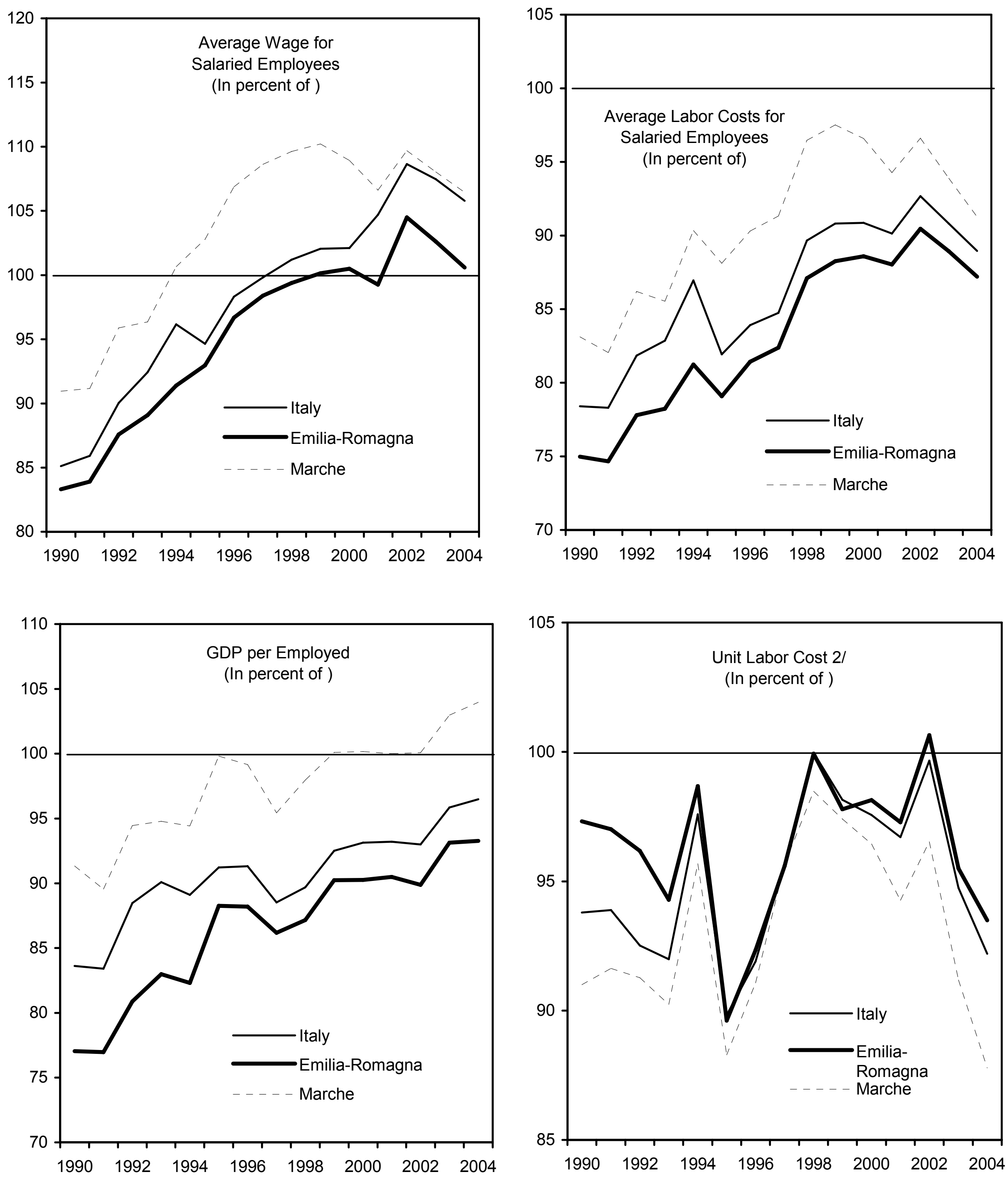
7. **Given the small size and location, the Sammarinese authorities have limited leverage on macroeconomic outcomes in the short run**. Monetary policy is non-existent, and the mobile factors of production imply that growth, fiscal outturns, and inflation depend heavily on developments in Italy. Given the reliance on an international reputation of good standing, foreign expertise and demand, especially in the financial sector, policy formulation needs to focus on long-term consequences, as short-term benefits are likely to be short-lived.

8. **San Marino remains vulnerable to external developments, especially in Italy**. The sharp drop in growth in 2002, partly due to the exodus of funds in response to an Italian tax amnesty, is testimony to this vulnerability. International efforts to reduce tax avoidance and bank secrecy and prospective changes in the tax regime or financial system in Italy may also affect the economy.

[5] The part of production based in Italy is likely to have been affected by the declining competitiveness of Italy vis-à-vis the rest of the world. However, this effect is difficult to quantify due to the lack of statistics regarding the direction of trade for San Marino and detailed information about the manufacturing sector.

Figure 4. San Marino: Unit Labor Costs Compared, 1990–2004

(In percent of Italy, Emilia-Romagna and Marche 1/)



Sources: Sammarinese authorities; SVIMEZ; and ISTAT. Data before 1995 are on an ESA 79 basis; thereafter they are on an ESA 95 basis.

1/ Emilia-Romagna and Marche are administrative regions of Northern Italy surrounding San Marino.
2/ Labor cost per employee divided by output per employee.

9. **The relative decline of traditional sectors adds a further dimension to the adjustment process**. Until recently, San Marino has adjusted quickly to shocks by successfully parlaying the relative flexibility of its economy and institutions to attract a continuous stream of factors of production from Italy. However, manufacturing, historically a powerhouse of the economy, contributes less to GDP every year, and tourism has stagnated, requiring investment to realize its full potential. The financial sector has taken up the slack, but it is uncertain whether it will adjust in time to weather the brunt of higher withholding tax rates. The pursuit of other avenues for growth would require significant improvements in the business climate, which would happen only over time.[6]

San Marino: Sectoral contribution to real GDP growth
(normalized by real GDP growth) 1/

	2000–01 average	2003–04 average
GDP	100.0	100.0
Industry	41.3	33.3
Financial services	-14.5	20.3
Commerce and tourism	21.8	14.6
Public sector	21.7	4.6
Other	29.8	27.2

Source: Sammarinese authorities; and Fund staff calculation.

1/ Measures the contribution of each sector to growth if growth were normalized to equal 100.

10. **Fiscal policy is constrained by the need to balance the twin objectives of preserving competitiveness while remaining sustainable.** On the one hand, tax and social security contribution rates have to stay low to attract businesses and commuters, and revenue collection is vulnerable to the mobile factors of production and risks to growth. On the other hand, expenditure is constrained by generous entitlements which are expected to increase over the medium term as the population ages.

11. **Policy design and monitoring is hampered by the lack of up-to-date data**. Key statistics are available with long lags (Appendix II), and the dissemination of statistics is behind times, hurting efforts to reach new markets and clients, while increasing the risk of being blind-sided by shocks.

III. Policy Discussions

12. **Discussions focused on measures to sustain strong growth over the medium term amidst these constraints**. In particular:

- how should fiscal policy safeguard competitiveness while remaining sustainable;
- how can the financial sector retain its competitive edge without compromising stability; and,
- what reforms in the labor market and business climate are needed to support growth?

[6] The authorities have prepared the legislative base to allow new businesses to operate, e.g., the registry of ships and aircrafts on Sammarinese territory.

A. Growth Outlook

13. **On current trends and barring unforeseen circumstances, growth is likely to remain strong in the near term but moderate thereafter** (Table 1). While traditional sectors are beginning to slow, the strong fundamentals and competitive advantage over Italy are likely to remain in place for now. Growth is, thus, expected to hover around 5 percent during 2007–08, but moderate thereafter to some 4–4½ percent by 2011, on the assumption that the financial sector would not be able to adjust to avoid the full impact of higher taxation, and that the small size of the economy will constrain diversification.

B. Fiscal Sustainability

14. **The draft three-year rolling plan for 2007–09 envisages a further erosion of the consolidated government budget surplus** (Table 2)[7]. The plan, binding only for 2007, envisages a further reduction in corporate taxes to 17 percent in 2007, and cautiously assumes no increase in nominal revenues from other sources. On the expenditure side, a key measure is to switch expenditure from current to capital spending, given the relatively modest investment outlays in the past, while holding the line on all other spending in nominal terms[8]. As a result, the central administration budget surplus is likely to decline steadily, despite plans to control current spending. The recent pension reform will begin to reduce the deficit of the social security fund from 2007 onward. However, the balances of public enterprises are expected to continue to deteriorate as tariffs fail to adjust in line with raw material cost increases.

15. **There was full agreement that the deterioration in public finances must be forestalled**. The authorities well understand the need for fiscal prudence to cover future contingent liabilities due to ageing costs and to create room for further tax cuts should they become necessary to preserve competitiveness. Given the limited room for maneuver on the revenue side, and the intention to increase capital spending, savings will have to come from current spending and further improvements in the balances of public enterprises. To help reduce transfers to the enterprises, discussions have already begun to establish a mechanism for automatic tariff adjustments from 2007 onwards. The authorities acknowledged that it was time to consider introducing demand-side measures (such as copayments) to further contain healthcare spending, which despite measures to restrict access and coverage, remains

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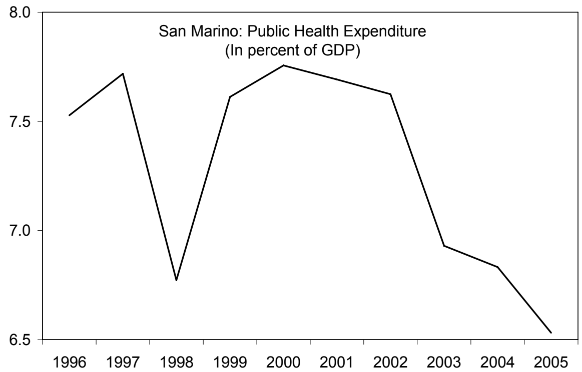
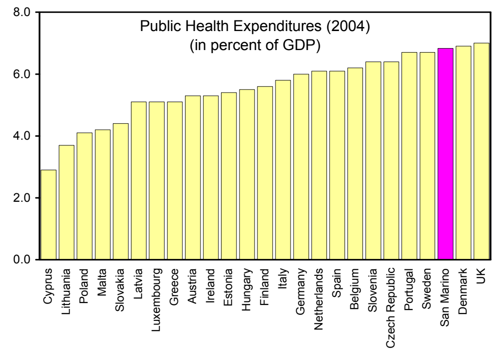
[7] Under the authorities' presentation, the three-year plan targets balanced budgets. However, this includes items under both revenues and expenditures which are typically considered as financing (e.g., a drawdown of deposits of the central administration and reserve accumulation of the social security fund). Under staff's presentation, these items have been reclassified as budget financing.

[8] This will be achieved by reducing new hiring and transfers to the private sector. In addition ad hoc transfers to the social security fund are not expected to recur because of improved management and consolidation of some pension funds.

high. Finally, budget accounting practices will be modernized in order to be better able to develop fiscal policy.



Sources: Sammarinese authorities; and Fund staff calculation.



Sources: European Commission, Aging Working Group; Sammarinese authorities; and Fund staff calculation.

16. **Further changes in the pension system are not off the table**. The 2006 pension reform compares favorably with reforms enacted elsewhere (Box 1). Nevertheless, actuarial calculations suggest that the pension fund would require increasing budget transfers for the foreseeable future to stay in surplus (Figure 5). Even then, demographic pressures will be so great that the pension fund will need to dip into its reserves to pay social security benefits after 2019. Alternative scenarios highlight the gravity of the problem. The authorities, well aware of this state of affairs, are not averse to further changes in the first pillar pension system, if they become necessary. For now, they intend to update actuarial calculations annually to better monitor sustainability, improve the management of the social security fund, and streamline and consolidate pension funds for non-salaried workers to prevent unforeseen overruns. They also plan to introduce a defined contributions second pillar in 2007 to bolster the private sector’s own efforts to save for retirement. Staff proposed that improvements in the labor market could also be considered a way to boost the deteriorating ratio of workers to retirees.

Box 1. Pension Reform

The pension system provides benefits to local residents and commuters. Major revisions introduced in 1993 failed to prevent a deterioration in social security balances. Recently, the government introduced changes to the existing PAYG mandatory system, envisaging:[3]

- Changes to the first pillar effective January 1, 2006, to be gradually introduced by 2019. These would:
    - increase retirement age (from 60 to 65 years);
    - raise the minimum contribution period and contribution rates;
    - reduce the pension base;
    - change the pension calculation formula to reduce benefits;
    - reduce replacement rates from 90 percent to 70–80 percent.
- The introduction of an optional defined-contributions second pillar scheme, replacing the old private pension insurance, effective 2007, with a view to making it mandatory later.

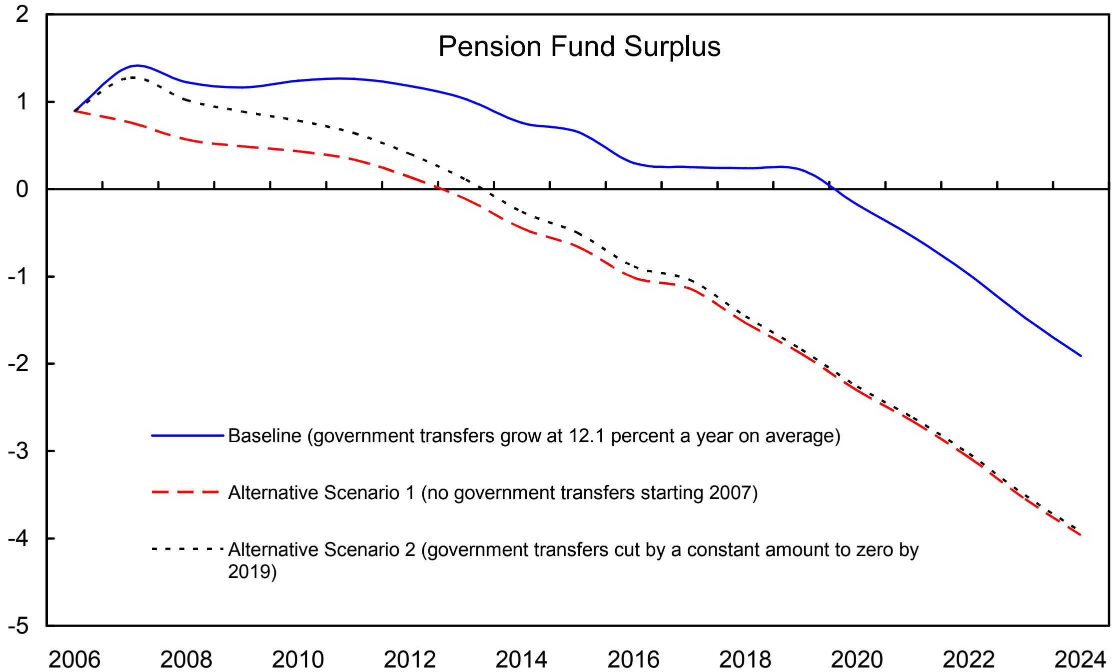
San Marino: Pension Systems in European Countries

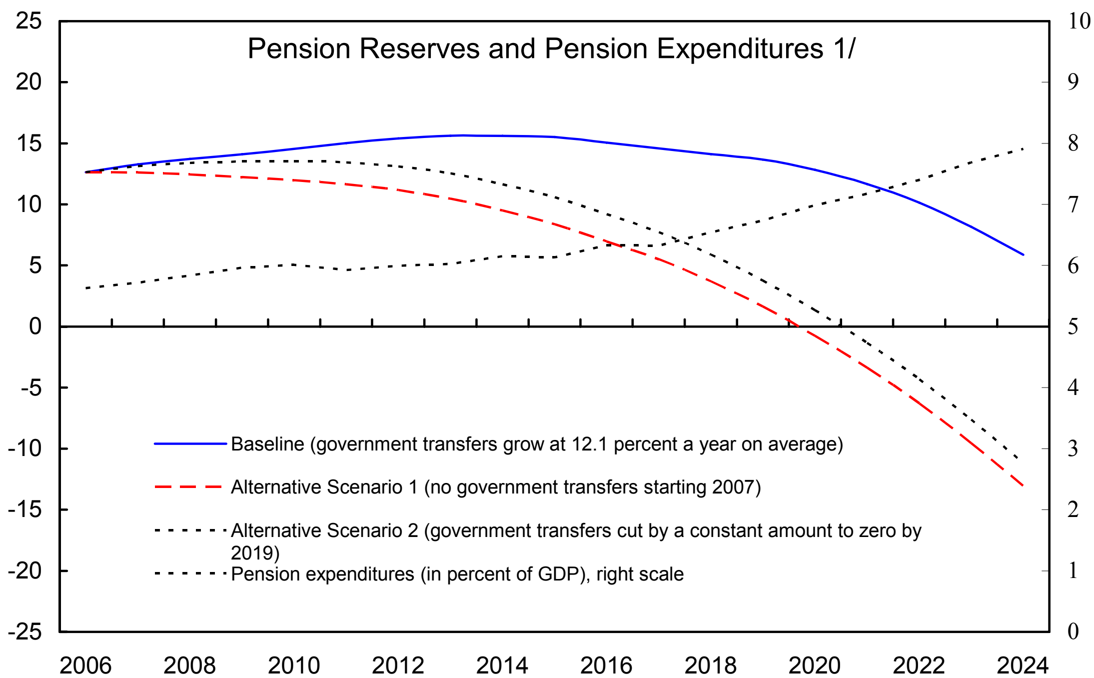
	Gross Replacement Rate	Minimum Retirement Age	Contribution Years to Take Early Retirement	Minimum Contribution Years
San Marino (before reform)	87	60/56	35	15/0
San Marino (after reform)	70-80	65	40	20
Austria	78.3	65	37.5	15
Belgium	37.3	65/63	35	5
Denmark	43.3	65	…	0
Finland	71.5	65/63	…	0
France	49.4	60	…	n.a.
Germany	45.8	65	35	5
Greece	84	65	15	15
Luxembourg	101.9	65	40	10
Ireland	30.6	66	n.a.	n.a.
Italy	78.8	65/60	35/39/40	20/5
Netherlands	68.3	65	40	10/5
Portugal	66.7	65	30	15
Spain	81.2	65	…	15
Sweden	64.8	61/65	…	…
United Kingdom	37.1	65	…	…

Sources: European Commission, Aging Working Group; OECD; and Sammarinese authorities.

[3] While some countries with a mobile labor force (e.g., Singapore) have introduced a defined contributions system, similar European countries (e.g., Luxembourg and Switzerland) have retained a defined benefits system.

Figure 5. San Marino: Pension fund simulations 1/
(In percent of GDP)

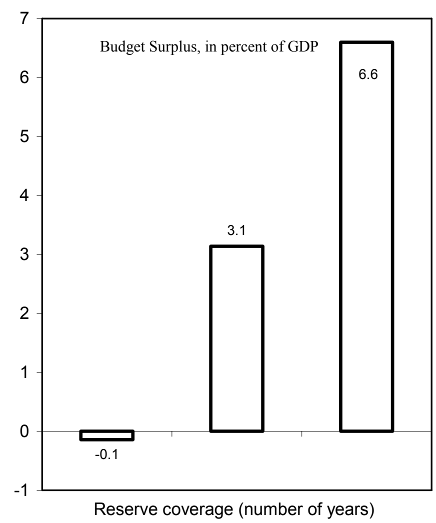




Source: Sammarinese authorities; and Fund staff calculations.
1/ For the dependent worker's pension fund. Based on the rolling three-year plan for 2007-09 and the authorities' actuarial calculations.

17. **More generally, staff proposed that it might be worth considering a rules-based mechanism to minimize the pressures arising from risks on the revenue side and high spending commitments**. Ideally, the rule would seek to ensure that the consolidated government's net assets are sufficient to cover its forthcoming nonreversible spending commitments. Without insisting on a specific rule at this stage, staff proposed that a target on the government's net assets might be the most appropriate for San Marino, given the problems of monitoring an expenditure-based rule, and since transparency and accountability are already addressed by the existing three-year rolling plans.[9] The authorities considered that the current system, whereby a part of the social security fund's total expenditures are earmarked for reserve accumulation and the reserves are protected from general budgetary use, provides sufficient safeguards. They also wondered whether targeting the net financial reserves might not be too restrictive as the current level of overall reserves were sufficient to meet pension expenditures for the immediate future. Staff observed that the current level of net reserves would be inadequate to cover spending on entitlements over the medium term even if they were sufficient now. The rule would not only help ensure adequate savings at the consolidated government level, but it could help stave off spending pressures from vested interests. As a purely illustrative example, staff scenarios show that, in contrast to the envisaged target for 2007, the consolidated government would need to run surpluses in the range of 1½ –2 percent of GDP a year to allow sufficient reserve buildup by 2011 to cover, say, about two years of projected pension and health expenditures, providing an appropriate and achievable cushion.

Alternative Scenarios for Reserve Coverage



1/ Reserves available to cover one, two and three years of pension and health spending (implying budget surpluses of 0.1, 3.4 and 6.8 percent of GDP respectively under the three alternative scenarios). Reserves are defined as the net financial worth of the general government (compiled according to the GFS Mannual 2001), excluding Cassa di Compensazione.

Source: IMF staff calculations.

C. Financial Sector Development and Stability

18. **The main challenge for the financial sector is to ensure a smooth adjustment to the new regulatory and economic environment**. Thus far, banks have successfully weathered the transition to tighter tax and bank secrecy legislation, managing to remain cost-competitive by European standards, although less so by international standards (Table 5). Financial institutions are gearing up to adapt to impending changes, with banks diversifying

[9] "Promoting Fiscal Discipline Over the Business Cycle".

into more sophisticated products and other markets, and non-bank financial institutions preparing to enter the mutual funds business.

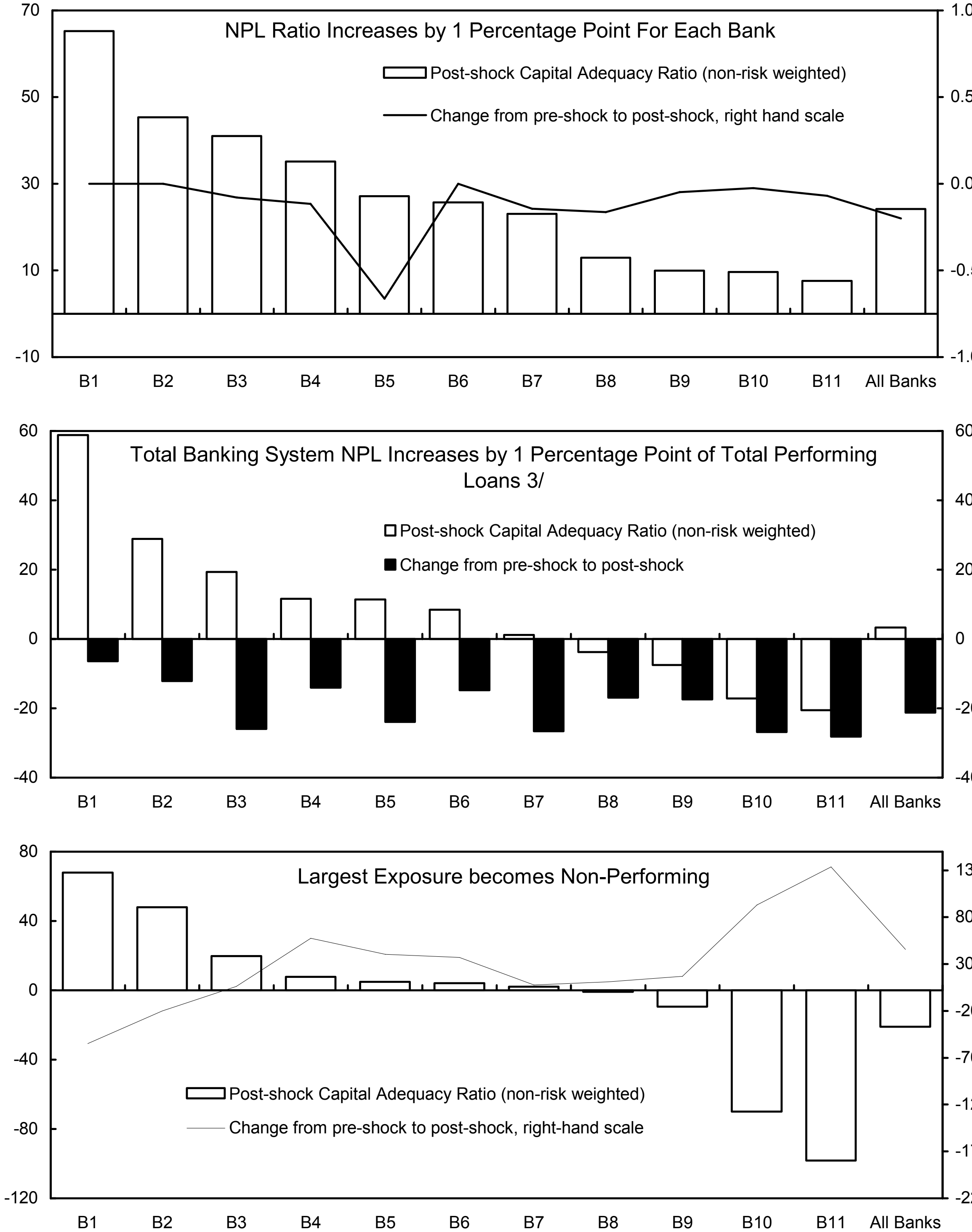
19. **Views differed on the ability of the financial sector to cope with the transition**. The transformation of the financial sector will, to some extent, depend on its ability to persuade traditional customers to assume greater risks, and to attract a broader clientele. Most banks and, to some extent, the CBSM, remained optimistic, pointing to bank secrecy, simpler modus operandi and personalized banking as factors that will continue to provide Sammarinese banks a comparative advantage. The CBSM also noted that given the small size of the sector, it would be able to withstand the effect of the withholding tax if it could capture even a small fraction of the global mutual fund business.

20. **Staff is less sanguine**. Clearly the financial sector is venturing into lines of businesses, products, and clients where it has less experience. In addition, staff analysis indicates that disparities in capital, credit quality, and risk management capabilities imply that some institutions are less prepared than others to successfully undertake this transition (Figure 6). Finally, San Marino would need to revamp its financial market infrastructure in a fairly brief period of time if it is to compete effectively in an increasingly financially integrated world, where competition is likely to be global and stiff. This would require significant investment in financial sector infrastructure including in human capital (Table 6), a daunting task given the limited resources at the CBSM's disposal and labor market constraints.

21. **It therefore called on the CBSM to closely monitor the financial system through greater oversight**. Staff supported plans to increase supervisory resources further, and urged that the initial round of in-depth on- and off-site supervision be completed quickly and, thereafter, be performed at regular intervals. It also indicated a need to ensure that banks and their clients are aware of the risks involved in the new lines of business through strengthened transparency and disclosure requirements, and that financial institutions are equipped to assess and manage their own risks.

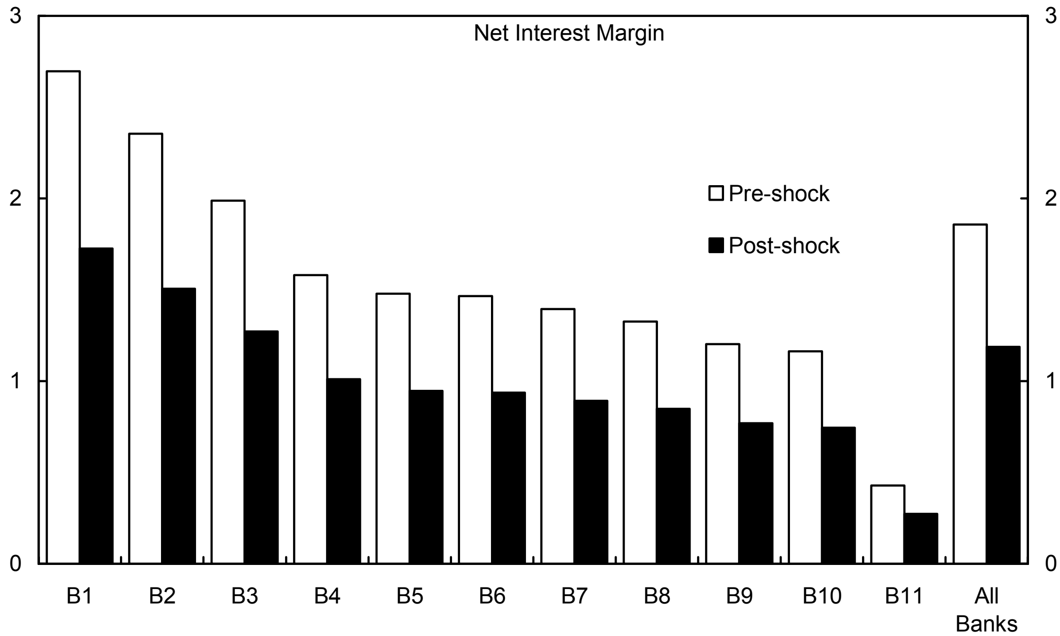
22. **The authorities are pressing ahead with plans to improve supervision**. Key initiatives in the pipeline are to: finish enacting implementing regulations consistent with the new financial sector law; further increase training and resources; hold banks to more stringent reporting standards and initiate in-depth off-site supervision on that basis; and complete the first round of on-site supervision. Deposit insurance is on the policy agenda, but will be introduced only after supervision capacity has been sufficiently improved. The CBSM is cooperating closely with other supervisory authorities to facilitate cross-border exchange of information, consolidated supervision, and improve business practices.

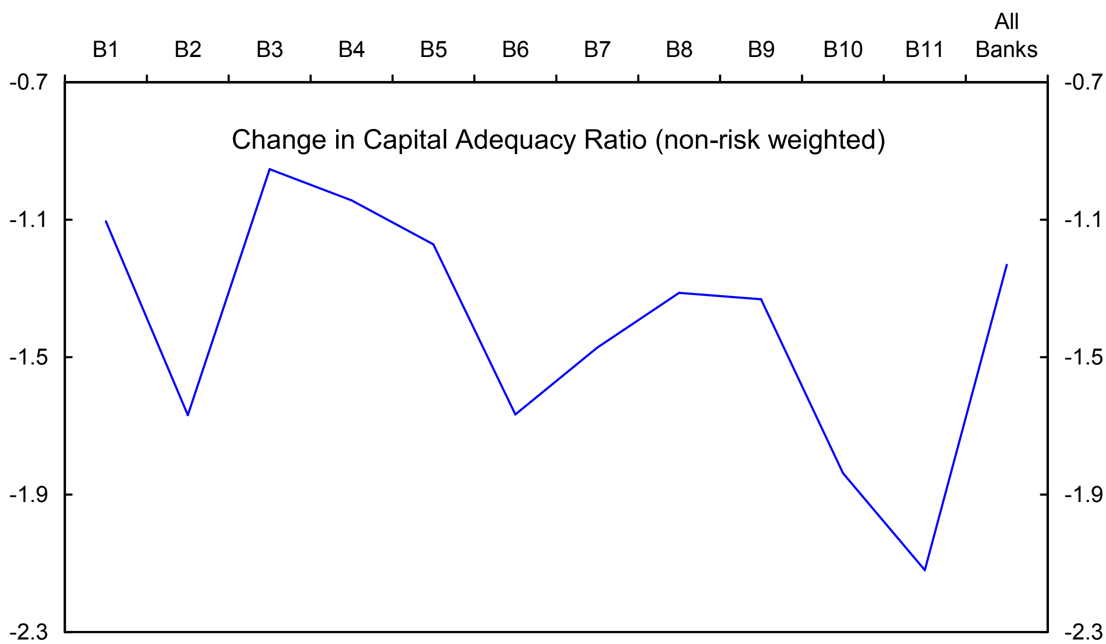
Figure 6. San Marino: Stress Tests on Credit Risk, 2005 1/, 2/
(in percent)



Source: IMF staff estimates.
1/ Analysis excludes Banca del Titano S.P.A. X-axis refers to banks.
2/ Assumes "haircut" (estimated average loss from NPLs) of 50 percent.
3/ Increase distributed across banks in proportion to existing NPL distribution.

Figure 6 (continued). San Marino: Stress Tests on Interest Rate Risk 1/, 2/
(Shock of 2 percentage points increase in LIBOR)





Source: IMF staff estimates.
1/ Analysis excludes Banca del Titano S.P.A.
2/ Data limitations preclude standard sensitivity tests. An alternative approach was used to assess interest rate sensitivity, namely a panel regression on balance sheet data for the four largest banks (1994-05) using the Feasible Generalized Least Squares estimator. The interest rate elasticity of net interest income (as a ratio to total assets) is estimated to be -0.32 (t = -2.13), a magnitude broadly consistent with the literature. The negative sign suggests that interest rate changes affect margins relatively more through banks' assets than through net interest incomes.

23. **The key task now will be to manage the transition and allow the CBSM the necessary room to implement the new supervisory framework in an arms-length manner**. The government and the CBSM are collaborating effectively to resolve problems in the financial system. Nevertheless, pressures from vested interests may arise down the road and it will be important to ensure that the CBSM's independence is not compromised, especially in licensing, supervision, and extraordinary administration of problem institutions. Greater autonomy in the financing of the central bank's budget would be a step in this direction.

24. **The authorities have requested a Financial Sector Assessment Program (FSAP) which should further examine these issues**. The next AML/CFT mutual evaluation by MONEYVAL is scheduled for spring 2007.

D. Structural Reforms and Competitiveness

25. **San Marino's intention to diversify and modernize its economy puts a premium on flexible labor markets**. Recent initiatives are useful and have helped improve competitiveness. However, they do not go far enough as they mostly target blue collar workers. As a result, economic activity is running up against capacity constraints for growth because of the difficulty in hiring the highly-skilled labor force needed to compete effectively in a global economy. This is specially true in the financial sector where the need for high-skilled multilingual labor is paramount, as demonstrated by other financial centers which have circumvented this impediment to sophistication by attracting the right talent from abroad.

26. **The constraints are manifold**. Procedures to hire non-resident workers are lengthy because of the need to establish the unavailability of the required skills from among residents currently listed as unemployed. While there are plans to ease these restrictions somewhat in 2011, businesses consider this to be too little and too late. Restrictions on the length of work contracts that can be offered to non-residents and uncertainties regarding the tax treatment of commuter workers from Italy make it difficult to attract the best qualified workers. The lack of a regulatory framework hampers outsourcing, and restrictions on residency are a deterrent to attracting labor from further afield. In addition, active labor market policies are not well designed: they are costly to the budget; they do not have the support of the labor force as they entail temporary income losses; and they are ripe for abuse by firms which could use them merely to reduce costs than to improve workers' productivity.

27. **The authorities are cognizant of the need to improve labor market flexibility, but progress is likely to be slow due to entrenched vested interests**. The small territory and generous entitlements limit the extent to which residency can be opened up. Maintaining low unemployment is an important priority and explains the preference for training over hiring non-residents. To this end, the authorities are collaborating with Italian and Sammarinese universities to help improve the skills of the Sammarinese work force. While sympathetic to

these concerns, staff noted that the rapid transition of the economy underscores the need to increase the supply of skilled labor quickly, and that the right skills may not be available simply through training. The incentive structure for active labor market policies also needs a rethink to achieve greater buy-in. Finally, eliminating the "employer of last resort" role of public enterprises, and further containing generous public sector pay scales would make private sector employment relatively more attractive.

28. **Thanks to business-friendly policies, San Marino's business climate compares favorably with its competitors (Table 7)**. New initiatives are being planned: further tax reductions, a resumption of discussions with Italy regarding an economic cooperation agreement, and improvements in public administration. Given the rapid changes in the global economy, improvements in the business climate are, by necessity, a work in progress, and thus, existing initiatives would need to be continually upgraded on the basis of lessons that emerge during implementation. An important priority for the authorities is to finalize the cooperation agreement with Italy to clarify the terms of economic engagement in important areas[10]. Staff also urged that the authorities finish upgrading the laws of the country to ensure full compliance with international anti-money laundering provisions as this would help open markets hitherto closed to San Marino.

E. Statistics

29. **Despite some improvements, data shortcomings remain (Appendix II)**. Staff pressed for shortening the time lag in producing statistics and improving dissemination as a matter of priority. The authorities agreed to participate in the GDDS.

IV. Staff Appraisal

30. **Macroeconomic conditions are benign and are likely to remain so in the near term**. After faltering briefly earlier in the decade, growth is once again on the upswing, bolstered by a recovery in Italy and a thriving financial sector. A raft of reforms have been initiated, which bode well for the resilience of the economy to shocks. Past fiscal deficits have been reversed and public debt remains low. Nevertheless, revenue losses from tax cuts and deteriorating balances of public enterprises will lead to a sharp reduction in the budget surplus in 2006–07. Reflecting improved macroeconomic prospects both domestically and in Italy, the financial sector appears to be in good shape. Financial supervision has been stepped up and is beginning to produce results.

31. **Reforms need to continue to help the economy adjust to the changing global environment and to improve competitiveness**. San Marino's small size and location make

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[10] This would facilitate, inter alia, the operation of Sammarinese financial institutions in Italy, the operation of Italian businesses in San Marino, the registration of Italian aircrafts in San Marino, and joint initiatives on health services.

it particularly vulnerable to policy changes in Italy and Europe. More flexible and modern institutions and markets are therefore needed to facilitate quick adjustment to changing circumstances and ease the transition toward an economy which is increasingly reliant on the high value-added service sectors. Fiscal policy would perforce need to play a key role in maintaining the competitiveness of the economy, while limiting the vulnerability arising from the combination of a mobile tax base and generous entitlements.

32. **Public finances need to be shored up as a matter of priority**. Unless corrective action is taken, the consolidated government budget surplus will decline further in 2007–09. It might be advisable to target a somewhat larger surplus than currently envisaged, to the tune of some ½ –1 percent of GDP. Revenue losses from tax cuts should be offset by broadening the tax base, and public enterprises must be allowed to operate as viable commercial entities by permitting tariff adjustments in line with growing raw material costs. The government's efforts to increase tariffs and implement a system of automatic tariff adjustments are welcome. Further cuts in current spending could be made, including reductions in healthcare spending through demand-side measures. A second round of reforms in the first pillar pension system may be warranted if the fiscal position does not improve sufficiently. A defined contributions second pillar pension system would help cushion the impact of further modifications to the first pillar, and should be introduced as planned.

33. **The government should consider introducing a fiscal rule to build adequate savings to finance ageing-related costs over the medium-term**. A rule based on the consolidated governments' net assets and liabilities would seem appropriate as this would directly take into account the financing of contingent fiscal liabilities. Planned improvements in budget accounting would help with the execution of this rule. Preliminary calculations suggest that, under a rule balancing the government's net assets and liabilities, surpluses of 1½ - 2 percent of GDP at the consolidated government level would be required to finance pension and health expenditures over approximately a two-year period.

34. **The modernization of the financial sector should be managed with care**. The CBSM has started taking the lead in financial sector matters, until this year exclusively within the government's purview, and it should be allowed the necessary room to manage the transition expeditiously. The newly enacted regulatory framework should be implemented in an arms-length manner, and the central bank's independence in licensing, extraordinary administration and supervision should not be compromised.

35. **The CBSM should provide greater oversight of the financial sector**. While the withholding tax has not yet hurt competitiveness, institutions are bracing for the full impact of this tax down the road by venturing into new lines of business and clientele where they have less experience. Moreover, a wide variance in capital, credit quality and risk management capabilities indicate that not all financial institutions are equally equipped or able to cope with this transition. These risks would need to be closely monitored and to this end, supervisory resources should be beefed up further and the first round of in-depth off-site

and on-site supervision completed expeditiously. The planned introduction of deposit insurance should await the improvement in supervisory capacity. The authorities' decision to participate in the FSAP is timely and welcome.

36. **The labor market needs to adjust to meet the demand for high-skilled labor of the rapidly growing service sectors and to improve competitiveness**. More flexibility would be required in procedures to hire non-residents, work contract tenures, and granting residence permits. Regulations would be needed to facilitate outsourcing and the incentive structure for active labor market policies should be amended to ensure that they effectively enhance productivity.

37. **Improvements in the business climate would need to continue**. The consolidation of regulations into a single corporate law and the planned streamlining of public administration should help businesses. The regulatory framework should be continually updated in line with the times. The most important remaining challenges are to finalize the cooperation agreement with Italy, and to finish upgrading the laws of the country to ensure full compliance with international anti-money laundering provisions.

38. **Finally, the long lags in producing and disseminating statistics should be reduced as a matter of priority**. This would aid policy assessment and development. The authorities' decision to participate in the GDDS is most welcome.

39. It is proposed that the next Article IV consultation be held on a 24-month cycle.

Table 1. San Marino: Selected Economic and Social Indicators, 2001–07

	2001	2002	2003	2004	2005	2006	2007
					Est.	Proj.	
	(Annual percentage change, unless noted otherwise)						
Output and prices							
Real GDP 1/	5.5	0.3	3.9	4.6	5.0	5.0	4.9
Employment	5.5	0.7	0.5	2.8	1.2	2.8	…
Unemployment rate (end of year; in percent)	2.9	3.9	4.1	3.4	3.6	3.3	…
Inflation rate (annual average) 2/	2.8	2.3	2.5	1.4	1.7	1.7	1.5
Nominal GDP (in millions of euros)	911	935	995	1,061	1,134	1,213	1,293
	(In percent of GDP)						
Consolidated government							
Overall balance	…	0.8	5.2	3.4	5.8	2.0	0.8
Primary balance	…	1.0	5.4	3.7	6.1	2.3	1.1
Gross debt (loans)	…	5.3	4.7	5.4	4.6	3.6	3.1
	(In percent of GDP, end of period)						
Net foreign assets							
Deposit money banks	60.4	139.2	101.1	61.2	70.3	…	…
Central bank	15.2	17.1	20.0	24.5	26.4	…	…
	(In percent of GDP, unless noted otherwise)						
External accounts							
Trade balance 3/	-6.0	-9.7	-9.5	-5.1	…	…	…
Exports 3/	184.8	177.6	177.1	186.1	…	…	…
Imports 3/	191.5	187.9	185.5	190.2	…	…	…
Compensation of employees, net	9.2	9.7	9.1	8.9	…	…	…
Gross international reserves (in millions of U.S. dollars)	133.5	183.4	252.7	355.6	354.0	…	…
Number of tourists (in millions) 4/	3.0	3.1	2.9	2.8	2.1	2.1	…
Exchange rate (euros per U.S. dollar, end of period)	1.1	1.1	0.9	0.8	0.8	0.8	…
Nominal effective exchange rate index (Italy) 5/ 6/ 7/	101.9	104.4	110.6	112.6	111.9	111.8	…
Real effective exchange rate index (Italy) 5/ 6/ 7/	101.4	103.8	110.2	112.1	111.0	110.7	…
Fitch Issuer Default rating 8/	AA						
Social indicators							
GDP per capita (current US$, 2005)	37,559						
Ratio to per capita GDP of :							
Italy	1.2						
EU-15	1.1						
Population (2006)	30,368						
Population density (2006, persons per km2)	496						
Life expectancy (2006)							
Male	78.6						
Female	85.5						
Literacy	96%						

Sources: Sammarinese authorities; U.S. Department of State; and Fund Staff estimates. Data for 2006–07 are Fund Staff estimates and projections.

1/ Fund staff estimates for 2005.
2/ Data break in 2004. Data for 2004 onward are based on new CPI (December 2002=100).
3/ Based on national accounts data.
4/ Data break in 2005 due to change in methodology for calculation.
5/ Annual average.
6/ Average of Jan–July for 2006.
7/ The average of monthly index in 2000=100. A larger value implies appreciation.
8/ Long-term, foreign currency rating. Italy's Fitch long-term foreign currency IDR is AA-.

Table 2. San Marino: Public Finances, Accrual Basis, 2002–12 1/

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
					Est.		Budget			Proj.	
	(In percent of GDP, unless noted otherwise)										
Central Administration Operations											
Revenues 2/	27.4	28.7	28.7	29.2	26.6	24.7	23.7	23.0	22.2	21.5	20.8
Tax	21.2	22.1	21.6	22.8	20.9	19.6	18.9	18.3	17.8	17.3	16.8
Direct 2/	10.6	10.0	9.7	9.9	7.8	7.4	7.1	6.9	6.7	6.4	6.2
Import tax 2/	8.2	9.5	9.2	9.7	9.0	8.8	8.5	8.1	7.8	7.5	7.3
Other indirect taxes	2.4	2.5	2.7	3.2	4.1	3.3	3.3	3.3	3.3	3.3	3.3
Non-Tax 2/ 3/	6.2	6.7	7.1	6.5	5.7	5.1	4.9	4.6	4.4	4.2	4.1
Expenditure	29.7	26.7	27.5	25.0	26.3	25.3	24.0	23.2	22.4	21.6	20.9
Current expenditure	27.1	24.5	24.4	23.0	23.8	21.9	20.1	18.8	18.0	17.2	16.5
Wages & Salaries	9.7	9.3	9.0	8.8	8.7	8.4	7.8	7.2	6.8	6.4	6.1
Transfers to Public Sector	13.4	11.4	11.1	10.6	10.9	9.6	9.0	8.6	8.4	8.2	8.0
o/w ISS	10.0	7.8	7.8	7.5	7.5	6.5	6.2	5.9	5.8	5.7	5.6
Transfers to Private Sector	1.0	0.8	0.7	0.7	1.0	0.8	0.7	0.7	0.6	0.6	0.5
Interest Payments	0.3	0.2	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.2	0.2
Others 4/	2.7	2.8	3.3	2.6	2.9	2.8	2.3	2.1	2.0	1.9	1.8
Capital expenditure	2.7	2.2	3.1	2.0	2.6	3.4	3.9	4.4	4.4	4.4	4.4
Transfers to Public Sector	0.3	0.8	0.7	0.7	0.9	1.5	1.5	1.4	1.4	1.4	1.4
Others	2.3	1.4	2.4	1.3	1.7	1.9	2.4	3.0	3.0	3.0	3.0
Balance (including transfers)	-2.4	2.1	1.2	4.2	0.3	-0.6	-0.3	-0.2	-0.2	-0.1	-0.1
Financing	2.4	-2.1	-1.2	-4.2	-0.3	0.6	0.3	0.2	0.2	0.1	0.1
Net Debt Financing	-0.1	-0.2	1.0	-0.5	-0.7	-0.3	-0.2	-0.2	…	…	…
Change in Deposits	-5.1	-1.9	-5.3	-1.6	0.2	0.8	0.4	0.3	…	…	…
Change in Net Government Arrears	7.4	-0.2	2.5	-2.4	0.0	0.0	0.0	0.0	…	…	…
Asset Sales	0.2	0.3	0.7	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Consolidated government											
Overall balance of the consolidated government (excluding transfers)	0.8	5.2	3.4	5.8	2.0	0.8	1.0	1.0	0.9	0.9	0.8
Central administration operations (excluding transfers)	9.1	11.2	10.4	13.3	9.8	8.8	8.7	8.3	8.1	7.9	7.8
Public enterprises (excluding transfers)	-0.6	-0.3	-0.6	-1.0	-1.9	-2.9	-2.8	-2.6	-2.5	-2.4	-2.3
Social security fund (excluding transfers)	-7.7	-5.8	-6.4	-6.5	-5.9	-5.0	-4.9	-4.7	-4.7	-4.6	-4.6
Memorandum Items:											
Public debt	5.3	4.7	5.4	4.6	3.6	3.1	2.6	2.3	2.1	2.0	1.9
Reserves of the consolidated government 5/	…	11.6	15.5	19.0	19.8	19.4	19.3	19.1	18.9	18.8	18.7
Nominal GDP (In millions of euros)	935	995	1,061	1,134	1,213	1,293	1,374	1,457	1,542	1,633	1,725
Real GDP growth (y-o-y percent change)	0.3	3.9	4.6	5.0	5.0	4.9	4.7	4.5	4.3	4.3	4.1
Change in GDP deflator (y-o-y percent change)	2.3	2.5	2.0	1.8	1.8	1.6	1.5	1.5	1.5	1.5	1.5
Overall balance of public enterprises (including transfers)	0.9	1.0	0.8	0.6	0.2	0.0	0.0	0.0	…	…	…
Overall balance of social security fund (including transfers)	2.2	2.1	1.4	1.0	1.6	1.5	1.3	1.2	…	…	…

Sources: Sammarinese authorities; and staff estimates.

1/ Projections for 2007–09 based on the three-year rolling plan. The decline in direct taxes partly reflects an increase in tax exemption for house purchases; the decline in non-tax revenues partly reflects a decline in profit transfers from public enterprises. Import taxes remain robust in line with growing trade with non-EU countries. Current expenditures are assumed to decline and capital expenditures to increase in line with the authorities' commitments.
2/ Net of tax reimbursements.
3/ Includes custom duties, state monopolies, other special revenues, revenues from financial assets, interests on credits and deposits.
4/ Includes purchases of goods and services, remunerations for consultancies, contribution to interest payments on publicly subsidized loans, and transport costs.
5/ Net financial wealth according to the *Government Financial Statistics Manual 2001* , minus the stock of unemployment compensation fund (Cassa di Compensazione).

Table 3. San Marino: Structure of the Financial System

	2000	2001	2002	2003	2004	2005	2006Q3
Number							
Banks	6	8	9	10	11	12	12
Domestic-majority owned	3	3	4	5	6	7	7
Foreign-majority owned	3	5	5	5	5	5	5
Financial Companies 1/	...	...	29	36	39	42	44
Financial system assets (in millions of Euro)							
Banks 2/	5,049	6,069	6,109	6,413	7,155	7,723	8,634
o/w foreign-majority owned 2/	1,873	2,182	2,150	2,165	2,442	2,642	2,740
o/w domestic-majority owned 2/	3,177	3,887	3,959	4,248	4,712	5,081	5,894
Financial Companies 1/	...	...	...	...	701	890	906
Assets as percent of GDP							
Banks	601	653	653	644	674	681	...
o/w foreign-majority owned 2/	223	235	230	218	230	233	...
o/w domestic-majority owned 2/	378	418	423	427	444	448	...
Memo							
GDP (millions of Euro)	840	929	935	995	1061	1134	...

Sources : Central Bank of the Republic of San Marino, balance sheets data and regulatory call reports; International Monetary Fund and staff calculations.

1/ Financial Companies extend credit and provide investment services (including security dealing), but are not allowed to accept deposits.

2/ Data are from International Financial Statistics.

Table 4. San Marino: Financial Soundness Indicators of the Banking Sector, 2000–06

	2000	2001	2002	2003	2004	2005	2006Q3
Capital adequacy							
Regulatory capital as percent of non-risk weighted assets 1/	...	...	...	...	22.8	23.1	19.6
Regulatory Tier I capital to non-risk weighted assets 1/	...	...	...	...	26.2	25.3	22.3
Capital as percent of assets	12.9	12.3	12.7	13.1	12.1	12.3	12.1
Asset composition and quality							
Sectoral distribution of bank credit to the private sector (as percent of total credit to private sector) 1/							
Government	8.6	5.5	9.3	12.0	5.8	6.6	...
Banks and other financial intermediaries	24.2	29.4	33.2	18.9	28.1	18.4	...
Non financial corporations	20.2	24.7	28.8	49.4	41.5	43.8	...
Consumers	30.2	25.8	21.2	14.6	20.2	29.5	...
Other	17.0	14.6	7.5	5.2	4.3	1.7	...
Sectoral distribution of bank credit to corporations (as percent of total loan exposure) 3/							
Financial	37.5	49.2	53.2	38.0	51.5	51.4	...
Industry	27.0	33.8	30.8	22.1	35.1	31.3	...
Construction & Real estate	20.1	9.4	8.2	9.1	7.1	4.3	...
Services	15.4	7.5	7.8	30.8	6.3	12.9	...
Geographical distribution of bank credit (as percent of total bank credit)							
San Marino	45.8	51.4	46.0	19.8	26.2	26.3	...
Other countries	54.2	48.6	54.0	80.2	73.8	73.7	...
Asset quality							
Non-performing loans (NPL) as percent of gross loans 4/	1.1	1.5	1.2	1.2	0.9	2.0	1.5
Provisions + write-offs as percent of NPL	428.3	327.5	363.9	394.3	499.6	292.4	332.2
NPL net of provisions as percent of tier I capital	...	...	...	3.1	3.1	1.0	0.1
Large exposures as percent of tier I capital 5/	...	...	...	98.6	112.6	112.9	121.5
10-largest credit to net credits 6/	...	...	...	63.5	56.0	56.4	45.8
Earnings and profitability							
Return on average assets (ROAA)	1.5	0.8	0.7	0.8	0.7	0.8	...
Return on average equity (ROAE)	12.0	6.3	5.4	6.3	4.9	5.8	...
Net interest margin (net interest income as percent of interest bearing assets)	2.1	2.0	2.0	2.0	1.9	0.0	2.0
Gross income as percent of average assets	2.3	1.7	1.6	1.7	1.5	1.6	2.4
Net interest income as percent of gross income	65.4	78.2	76.9	74.7	75.6	73.9	77.8
Non-interest income as percent of gross income	34.6	21.8	23.1	25.3	24.4	26.1	22.3
Trading income as a percent of gross income	9.9	-0.4	0.3	6.1	4.4	3.6	-0.3
Non-interest expenses as percent of gross income	22.9	29.7	31.5	30.1	32.3	31.9	29.9
Personnel expenses as percent of non-interest expenses	51.9	50.3	49.1	50.9	52.4	48.3	49.8
Spread between reference loan and deposit rates	3.8	3.9	3.0	2.8	2.7	2.5	1.9
Liquidity							
Liquid assets as percent of total assets	70.5	69.4	67.5	60.8	56.1	54.4	...
Liquid assets as percent of borrowed funds	209.5	138.4	127.8	129.8	115.6	119.7	...
Foreign currency loans as percent of total loans	3.2	2.1	1.5	3.4	2.6	2.2	3.2
Foreign currency liabilities as percent of total liabilities 7/	0.6	0.5	1.0	0.8	1.5	1.4	1.6
Deposits as percent of assets	33.4	32.1	32.9	35.9	37.6	48.5	53.8
Loans as percent of deposits	69.6	66.9	80.6	85.9	100.1	81.9	81.0

Sources : Central Bank of the Republic of San Marino, balance sheets data and regulatory call reports; Bank Scope; International Monetary Fund and staff calculations.

1/ Available since 2004.
2/ It includes both public and private sectors. Data refers only to residents.
3/ It includes residents and non residents. Sectoral ratios are calculated on total credit to resident and non resident corporations.
4/ NPL are defined as loans for which a legal claim has been filed.
5/ Large exposures are defined as credit accounts greater than 2/5 of capital.
6/ The indicator refers to the first 10 largest credit accounts and it is calculated on net loans.
7/ Foreign currency liabilities include foreign currency deposits only.

Table 5. Selected Financial Markets: Financial Soundness Indicators, 2000–04 averages 1/

	San Marino	Euro area	Italy	Hong Kong	Liechetenstein	Luxembourg	Singapore	Switzerland	U.A.E.
Capital adequacy									
Tier-1 capital to risk-weighted assets	12.6	8.3	8.1	13.3	12.9	12.9	12.8	11.8	12.6
Capital to assets ratio	12.9	4.0	7.1	12.8	11.8	4.7	11.9	4.4	12.4
Contingent liabilities to assets ratio	57.7	111.7	14.2	9.1	3.7	12.1	4.9	12.5	72.7
Contingent liabilities to liquid assets ratio	90.0	322.9	44.7	31.6	7.8	24.0	17.7	25.1	197.0
Contingent liabilities to equity ratio	447.8	2,782.0	196.5	70.6	31.8	259.1	41.3	295.2	585.9
Z-score 2/	28.9	24.1	34.5	25.9	18.1	47.9	39.9	18.5	25.8
Asset quality 3/									
NPLs to gross loans 4/	1.2	1.5	3.4	3.6	0.3	0.3	5.6	1.5	6.6
Provisions to NPLs 4/	396.3	96.3	51.9	70.3	444.9	130.9	72.1	208.7	109.3
Provisions to gross loans 4/	3.3	1.4	1.7	2.3	0.5	0.4	4.0	2.4	6.8
NPLs net of provisions to operating income	-27.7	3.3	38.2	24.9	-2.3	-1.5	29.0	-10.5	-6.2
Earnings									
Return on average assets (ROAA)	0.9	0.3	0.4	1.8	1.2	0.5	1.4	0.6	2.0
Return on average equity (ROAE)	7.0	8.3	5.8	13.7	10.8	11.6	11.3	14.8	16.2
Borrowed funds to total liabilities and equity	46.4	26.6	25.3	8.8	6.4	10.7	1.6	17.4	4.9
Cost to income ratio	41.4	65.3	87.3	34.2	60.4	57.5	36.3	81.7	35.9
Net interest margin (to interest earning assets) 4/	2.0	1.1	2.0	1.5	1.2	0.8	1.8	1.4	2.6
Net interest income ratio to total net income	73.8	58.6	74.3	61.1	39.2	42.9	65.4	32.6	69.8
Noninterest expenses to total expenses	47.3	28.7	53.3	44.3	56.7	18.2	47.7	54.9	47.0
Profits before taxes per employee (thousands of dollars)	256.9	64.9	47.4	379.2	200.7	140.8	214.1	104.6	101.4
Loans per employee (millions of dollars)	603.4	724.5	482.4	1,100.6	554.2	542.8	559.9	427.3	250.3
Liquidity									
Liquid assets to total assets	64.9	34.5	31.0	29.9	48.6	50.5	29.6	48.1	36.3
Loans to total assets	24.4	40.6	50.5	38.0	32.9	25.5	39.7	31.4	47.3
Loans to deposits and short-term funding	30.9	64.9	95.3	54.8	42.5	34.1	53.2	43.3	62.9
Net loans to deposits	30.9	49.6	68.9	49.2	39.3	29.8	52.4	39.0	59.1
Funding volatility ratio 5/	-57.2	-12.1	-7.9	-30.5	-83.6	-80.5	-40.4	-60.9	-50.6

Sources: Bankscope; IMF, *International Financial Statistics*; and IMF staff calculations.

1/ Refers to the banking sector.
2/ Measures the number of standards deviations a realization of returns has to fall to deplete equity (higher z-scores correspond to lower probability of insolvency risk).
3/ Loan classification varies across countries.
4/ For San Marino, the period covered is 2001–04.
5/ Calculated as total borrowed funds (volatile liabilities) net of liquid assets, to total assets net of liquid assets.

Table 6. San Marino: Selected Financial Markets 1/

	San Marino	Italy	Hong Kong	Luxembourg	Singapore	Switzerland	U.A.E.
Regulatory and institutional factors							
Bank licensing (central bank, MOF, both, or other)	Both 2/	Central Bank	Central Bank	Both 2/	Central Bank	Other 3/	Central Bank
Entry barriers to foreign banks (Y/N)	N	Y 4/	...	N	N	N	N
Barriers to cross-border financial flows (Y/N)	N	N	...	N	N	N	N
Risk-based supervision (Y/N)	...	...	...	...	Y	...	N
Basel I (Y/N)	Y	Y	...	Y	Y	Y	Y
Electronic banking (allowed/ not allowed)	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed	Allowed
Accounting standards (specify)	Local GAAP	IFRS	IAS	GAAP	SAS	IAS/GAAP	IFRS
Auditing standards (specify)	...	CNDCR 5/	...	GAAP	SSA	...	...
Deposit insurance (Y/N)	N	Y	Y	Y	Y	Y	N
Payments system (specify)	...	RTGS	RTGS	RTGS	RTGS	...	SWITCH and TTTS
Transparency							
Central Bank website (Y/N)	Y	Y	Y	Y	Y	Y	Y
Public availability of monetary and financial statistics (Y/N)	Y	Y	Y	Y	Y	Y	Y
Publication of audited bank balance sheets (Y/N)	Y	Y	...	Y	Y	Y	Y
Market structure							
Total number of banks	12	841	203	155	109	337	134
Domestic	7	770	77	4	5	...	48
Foreign	5	71	126	151	104	...	86
Share of total assets:							
Domestic banks	65.8	95.5	...	5.0	25.8	8.0	78.0
Foreign banks	34.2	1.6	...	95.0	74.2	92.0	22.0
Government-owned banks	...	0.1	...	...	...	...	64.0
Foreign subsidiaries and branches	...	2.8	...	18.0	...	0.6	...
Total number of non-bank financial companies	42	1,098	66	2,060 6/	3	...	227
Total number of insurance and reinsurance companies	...	208	1,936	95	156	...	47
Economies of scale and scope							
Deposit money banks total assets, (bln.US$)	7.7	4,155.7	8,002.8	1,072.5	842.6	2,186.8	173.7
Derivatives (daily turnover)	...	...	...	...	148.1	...	0.0
Consolidated international claims of deposit money banks on country (bln. US$)	...	416.9	159.1	401.7	268.1	503.2	32.3
Credit to the non-financial private sector to total credit ratio	74.9	...	91.0	...	36.0	73.1	78.0
Liquid liabilities to GDP ratio (depth)	268.8	52.8	...	945.2	2,235.5	135.8	86.0
Gross claims on private sector to GDP ratio	303.8	87.7	...	107.0	97.3	159.8	64.0
International economic links							
Deposit money banks foreign liabilities to total liabilities ratio	54.8	10.1	21.0	22.3	61.0	29.3	14.0
Number of domestic banks ranked in world top 1000	...	...	...	...	...	19	7
Deposit money banks foreign assets to total assets ratio	65.2	5.2	35.0	33.6	66.0	32.4	29.0
Credibility and creditworthiness							
International reserves (bln. US$) 7/	0.4	25.5	0.1	0.2	8.8	13.6	47.8
Deposit to loan ratio	91.8	46.7	181.0	49.2	72.2	79.4	116.0
Loans to the government to total loans ratio	0.6	15.6	...	33.4	22.5	6.7	11.3
Central bank credit to deposit money banks	0.0	0.0	...	3.1	...	...	0.0
Memorandum items							
Nominal GDP (bln.US$)	1.4	1,765.5	177.7	36.5	116.8	367.6	129.6

Sources: Bankscope; BIS; Bloomberg; IMF International Financial Statistics; and IMF staff calculations.

1/ Latest available information.
2/ Central Bank and Minister of Budget. In the case of San Marino, the Minister of Finance can overrule or object a decision by the supervisor to authorize a bank to function.
3/ Federal Banking Commission.
4/ Market contestability is limited and foreign entry has proven difficult.
5/ Commercialisti e dei Ragionieri (`CNDCR`).
6/ Investment funds.
7/ Excluding gold.

Table 7. Business Climate Indicators

	San Marino 1/	Italy	Hong Kong	Singapore	Switzerland	U.A.E.
Starting a business						
Duration (days)	9 2/	13	11	6	20	63
Cost (in percent of per capita GNI)	8 3/	15	3	1	2	36
Employing workers						
Index: Difficulty of hiring a new worker	n.a.	61	0	0	0	0
Index: Restrictions on changing number of working hours	n.a.	60	0	0	60	60
Index: Difficulty and expense of firing redundant workers	n.a.	40	0	0	10	0
Index: Rigidity of employment (average of 3 indices above)	n.a.	42	5	13	14	13
Firing cost (weeks of wages)	4	2	62	4	13	84
Registering property for business						
Time (days)	1-5	27	54	9	16	6
Cost (in percent of property value)	1.5-6	1	5	3	0	2
Protecting investors						
Index: Transparency of transactions	n.a.	7	10	10	0	4
Index: Director's liability for self-dealing	n.a.	2	8	9	5	7
Index: Shareholders' ability to sue for company misconduct	n.a.	6	9	9	4	2
Investor protection index (average of three indices above)	n.a.	5	9	9	3	4
Paying taxes						
Payments per year (number)	3	15	4	16	13	15
Time to prepare, file and pay (hours per year)	5	360	80	30	68	12
Total tax rate (in percent of profits)	19	76	29	29	25	15
Trading across borders						
Time to complete export procedures (days)	1 4/	15	5	6	17	18
Time to complete import procedures (days)	5 5/	21	5	3	18	16
Enforcing contracts						
Time (months)	24	39	7	4	7	20
Cost (in percent of debt)	n.a.	18	14	15	11	19
Closing a business						
Time to complete procedure (years)	1	1	1	1	3	5
Cost (in percent of estate)	n.a.	22	9	1	4	30
Recovery rate (cents on the U.S. dollar)	n.a.	40	79	91	47	10

Sources: Doing Business Database (http://www.doingbusiness.org/), World Bank Group; and IMF staff calculations.

1/ Data for San Marino are based on information provided by the authorities and staff estimates.

2/ In the case of limited liability companies or joint-stock companies and in the case of a simplified procedure (i.e. in 85 percent of the cases), duration is up to 15 days.

3/ For corporations; for individually-owned companies is about 1.5 percent.

4/ Issuing of the bill of lading takes 1 day; goods are then transferred to the customs point of destination and the invoice to the tax office.

5/ If imports are coming from non-EU countries, time is about 21 days.

REPUBLIC OF SAN MARINO – ANNEXES TO THE 2006 ARTICLE IV CONSULTATION STAFF REPORT

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APPENDIX I. SAN MARINO: FUND RELATIONS

(As of November 30, 2006)

- **Mission dates:** November 30–December 11, 2006.
- **Team:** Ms. Banerji (head), Mr. Nadal De Simone and Mr. Takizawa (all EUR), joined by Mr. Crispolti (OED).
- **Interlocutors:** Ministries of Finance (MoF) and Foreign Affairs (MoFA), the Central Bank of San Marino (CBSM), government agencies, labor unions, and private sector participants.
- **Recent political developments:** A center-left coalition government led by the Socialist Democrats came into power in June 2006. No major policy changes are expected.
- **Outreach:** The concluding statement has been published, as will be the staff report. The mission held a press conference.
- **Data:** Data shortcomings remain. San Marino does not participate in the GDDS (Appendix II).

I. **Membership Status**: Joined 9/23/92. Article VIII.

II. **General Resources Account**:	SDR Million	Percent Quota
Quota	17.00	100.00
Fund holdings of currency	12.90	75.88
Reserve position in Fund	4.10	24.13

III. **SDR Department**:	SDR Million	Percent Allocation
Allocation		
Holdings	0.80	N/A

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangements**: Prior to 1999 the currency of San Marino was the Italian lira. Since January 1, 1999 San Marino uses the euro as its official currency. The central monetary institution is the Banca Centrale della Republica di San Marino. Foreign exchange transactions are conducted through commercial banks without restriction at rates quoted in Italian markets. There are no taxes or subsidies on purchases or sales of foreign exchange. San Marino's exchange system is free of restrictions on the making of payments and transfers for current international transactions, except for those maintained solely for the preservation of national or international security and which have been notified to the Fund pursuant to Executive Board Decision No. 144-(52/51).[1]

VIII. **Article IV Consultation**: San Marino is on a 24-month consultation cycle; the last consultation discussions with San Marino took place during April 29–May 10, 2004 and concluded on 07/28/2004.

IX. **Technical Assistance**

Year	**Dept.**	**Purpose**	**Date**
1997	STA	Multisector assistance	3/97
2004	STA	Monetary and Financial Statistics	1/29–2/4, 2004
2005	MFD	Deposit insurance	11/05

X. **Resident Representative**: None.

[1] EU Regulations are not directly applicable to San Marino as a result of Article 249 of the Treaty Establishing the European Community, but they may well be applied as a result of the legal relationship between San Marino and Italy, acting on behalf of the European Union.

APPENDIX II. SAN MARINO: STATISTICAL ISSUES

Progress has been made, but there are important shortcomings in the statistical database due mainly to resource constraints. The authorities recognize these deficiencies, and requested and received a STA multisector TA mission in 1997, and a STA Monetary and Financial Statistics TA mission in 2004. Authorities also received assistance from STA in GFS compilation. On January 12, 2007, the authorities announced their intention to participate in the GDDS and named two National GDDS Coordinators. The authorities are planning to increase the frequency of website updates starting January 2007 in order to improve data dissemination.

Since 1992 the authorities have produced an experimental set of **national accounts**. Data for 1995 onward have been calculated in accordance with ESA95. The authorities have also calculated sectoral value added. However, output data are published with two-year delay. Consumer prices are collected directly at the source and published monthly with short delay. Furthermore, a business production index was launched in 2006, and the authorities are planning to compile a business sentiment index starting 2007.

Regarding the **government finance statistics,** the authorities have provided data for the consolidated central government as well as budgetary central government, extra budgetary accounts, and social security funds for 2002–05 in accordance with the *Government Finance Statistics Manual 2001* methodology. However, the data have been compiled with 1–2½ years lag. Beyond reporting to the Fund, **budgetary accounting** does not follow international best practice. The central government budget is written so as to close at par, which implies that standard financing items, such as amortization, are included as an expenditure while ”borrowing requirement” is included among the revenues. In the event, however, revenue shortfalls have been financed by (i) drawing down deposits at the central bank; (ii) changes in volumes of payables/receivables; and (iii) new loans. The **deficit/surplus** concept monitored by the authorities (the *avanzo/disavanzo d'esercizio*) is the difference between assessed revenues and committed expenditure on an accrual basis, and by the difference between asset float and liability float eliminated. This concept is different from a standard central government balance on an accrual basis, as it includes arrears and yet-to-be-collected revenues among accrued expenditures. The authorities launched a new publication on cross-country pubic finance data in 2006 based on existing data.

Regarding **monetary statistics**, the authorities have, since May 1997, provided balance sheet data on the commercial banks and the monetary authorities to the STA's EIS database. These data are provided on a quarterly basis, with approximately a six-week reporting lag. The authorities have introduced laws and took some measures to improve coverage and timeliness of banks' reporting, and the CBSM has improved sectorization (allowing for reliable identification of all transactions of the central government and the social security fund in monetary statistics) and expanded data collection to cover the offshore asset management activities of banks. The breakdown of deposits (and other assets and liabilities) between residents and nonresidents and the breakdown of short-term credit by public and private sector components are also available. However, there is no broad money survey and data on nonbank financial intermediaries are lacking.

San Marino does not compile **balance of payments accounts**; given the currency union with Italy and the subsequent introduction of the euro, the authorities have not considered this a high priority and have, therefore, not committed the necessary resources.

San Marino: Table of Common Indicators Required for Surveillance

(As of January 22, 2007)

	Date of latest observation	Date received	Frequency of Data[5]	Frequency of Reporting[5]	Frequency of Publication[6]
Exchange Rates	1/03/07	1/03/07	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	June 2006	Aug 2006	Q	Q	Q
Reserve/Base Money	June 2006	10/18/2006	Q	Q	Q
Broad Money	June 2006	10/18/2006	Q	Q	Q
Central Bank Balance Sheet	June 2006	10/18/2006	Q	Q	Q
Consolidated Balance Sheet of the Banking System	June 2006	10/18/2006	Q	Q	Q
Interest Rates[2]	1/3/07	1/3/07	D and Q	D and Q	D and Q
Consumer Price Index	Mar 2006	Aug 2006	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2005	Dec 2006	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government					
Stocks of Central Government and Central Government-Guaranteed Debt	2005	Dec 2006	A	A	A
External Current Account Balance					
Exports and Imports of Goods and Services	2004	July 2006	A	A	A
GDP/GNP	2004	July 2006	A	A	A
Gross External Debt					

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
[5] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[6] Reflects the assessment provided in the data ROSC (published in October 2002, and based on the findings of the mission that took place during April 2002) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); not observed (NO); and not available (NA).
[7] Same as footnote 6, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data.

Statement by Arrigo Sadun, Executive Director for Republic of San Marino and Valerio Crispolti, Advisor to Executive Director February 23, 2007

At the outset, we wish to convey our authorities' deepest appreciation for the work done by the Fund's mission team and for the high-quality paper, which underscores the progress made by San Marino's economy and identifies its medium-term challenges. The authorities have greatly benefited from the staff's advice and continue to enjoy an extremely fruitful relationship with the Fund. In the coming months, staff's recommendations will be at the center of policy discussions with unions and business associations.

Background

San Marino's economic performance remains robust, benefiting from an improved external environment and the implementation of important structural reforms that are now producing concrete results. In 2006, GDP growth is estimated to have reached a robust 5 percent, while inflation remained subdued. In this context, the unemployment rate is expected to show a further decline to about 3 percent – after a peak of 4 percent in 2003.

In July 2006, a new government took office with the mandate to revamp international cooperation agreements, most importantly with Italy; further consolidate San Marino's fiscal position; and support the integration of its financial system into global financial markets.

Fiscal policy

The authorities are fully committed to maintaining public finances on a sustainable path. They are well aware of the risks stemming from an erosion of the consolidated government budget surplus, and intend to implement appropriate measures to further consolidate the country's fiscal position.

On the revenue side, despite the limited room for maneuver due to San Marino's mobile tax base, the authorities intend to enhance revenue mobilization by further strengthening tax administration, while maintaining tax rates at low levels to preserve competitiveness.

On the expenditure side, our authorities aim to reduce the share of current spending over total expenses, so as to increase capital outlays. Such a strategy will provide San Marino with the modern infrastructure necessary for its transition to an economy increasingly based on high-value-added service sectors. Within this framework, measures have already been taken to reduce transfers to public companies: on February 1, 2007, tariffs were significantly adjusted, and a second round of adjustments is due on July 1, 2007, leading to a cumulative average increase of almost 14 percent in tariffs paid by households. Moreover, the authorities are pursuing a gradual reduction in the size of the civil service. In this respect, greater attention will be paid to making the civil service more effective, including by encouraging mobility within the administration, simplifying procedures, and streamlining red tape. To further contain healthcare spending, the government is considering implementing supplementary measures in the form of co-payments.

In 2006, following the Fund's recommendations, the pension system was thoroughly reformed so as to prevent a further deterioration in the social security balances. The reform also envisages the introduction of a defined contribution second pillar, whose nature is currently the subject of intense negotiations between the government and the relevant social counterparts (Box 1 in the staff's paper). In addition, the authorities intend to strengthen the management of the social security fund and to consolidate pension funds for non-salaried workers so as to prevent unforeseen overruns. Further, the government does not exclude the possibility of new changes to the first pillar pension, should the actuarial calculations indicate clear sustainability risks.

Finally, while carefully considering the staff's proposal for a fiscal rule to ensure adequate savings at the consolidated government level, the authorities remain under the impression that the current system already provides sufficient safeguards. In addition, they note that for an effective and transparent implementation of such a rule, further improvements in budget accounting would be necessary.

Financial sector

The development of a sound and modern financial system, capable of attracting foreign investors and competing with other international financial centers, is a priority in the authorities' agenda. Thus, several important measures have been taken to strengthen the institutional and regulatory framework, in accordance with staff's recommendations.

In 2005, the recently established Central Bank of San Marino (CBSM) was granted financial sector supervisory powers by the government, and a new financial sector law was passed to modernize and align the regulatory framework to international standards. More recently, the CBSM and the government implemented the necessary regulatory and fiscal measures to set up the Sammarinese mutual fund business.

The government acknowledges the importance of allowing CBSM to implement the new supervisory framework in an arm's-length manner and stands ready to further buttress its independence, if necessary. At the same time, CBSM is committed to enhancing oversight of the financial sector, including by strengthening transparency and disclosure requirements as well as by hiring additional staff. Accordingly, CBSM is currently finalizing a new banking regulation to further improve prudential supervision safeguards. CBSM is also recruiting additional supervisory resources.

Meanwhile, the CBSM has been able to start a more in-depth round of on-site supervision. This led to the discovery of irregularities in two small financial institutions -- currently under direct administration by the CBSM -- and, on February 15, 2007, to the immediate suspension of another financial company's activities for a period of six months.

To benefit from the introduction of international best practices, the authorities have been opening the system to greater international scrutiny. To this end, they have requested a Financial Sector Assessment Program (FSAP), which will also help them prioritize the necessary interventions to further strengthen the sector. Importantly, the authorities' efforts to develop the financial sector have been accompanied by the strengthening of anti-money laundering surveillance. San Marino has signed all the relevant international agreements, such as the 1990 Strasbourg Convention, the European Convention on Mutual Assistance on Criminal Matters, and the European Convention on Extradition. San Marino is also a member of the Council of Europe's Select Committee of Experts on the Evaluation of Anti-Money Laundering Measures. More recently, San Marino has become a member of the Egmont Group. The next AML/CFT evaluation by MONEYVAL is expected to take place in March 2007.

Statistics

Notwithstanding serious resource constraints, San Marino has made commendable progress in the compilation of statistics: data on fiscal accounts and on monetary and financial sectors are now produced according to international standards and published in the IFS. Nevertheless, the authorities acknowledge that further efforts are necessary to reduce current lags in the compilation of statistics and to improve dissemination practices. We are happy to inform the Board that the authorities intend to participate in the General Data Dissemination Standards (GDDS). In this regard, two National GDDS Coordinators have already been appointed.

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March 2, 2007

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2006 Article IV Consultation with the Republic of San Marino

On February 23, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Republic of San Marino.[1]

Background

San Marino has been undergoing a profound transformation. It has come a long way since the early part of this decade when growth was sputtering, public finances were precarious, and the economy was mired in old-fashioned modus operandi. Responding to global competition, San Marino is becoming a more dynamic economy oriented toward the service sectors, by modernizing its laws and regulations and opening itself to new opportunities for growth. At the same time, it is experiencing the impact of an ageing population and has started taking action on several fronts to ensure that there are enough savings to make good on the promise of generous entitlements to its residents.

These policies have begun to bear fruit. Output growth has rebounded to an estimated 5 percent in 2006, reflecting the recovery in Italy and Europe and improving competitiveness. Barring unforeseen circumstances, growth is expected to remain strong in the coming years. The budget deficits of yesteryears have been replaced by a string of surpluses through spending restraint, especially on wages and healthcare. However, revenue losses from tax cuts, increasing transfers to public enterprises, and spending overruns have eroded the budget surplus in 2006, and this trend will likely continue in 2007-09 under current plans. Nevertheless, public debt remains low, and an ambitious reform of the first pillar pension system has been enacted to combat ageing-related spending pressures.

[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. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Reflecting the healthy economy and an increase in international deposits, the financial sector appears profitable, liquid and well capitalized. A wide-ranging reform of the regulatory framework and supervision is underway to modernize the financial sector and make it conform to international standards. Financial institutions are adjusting, so far successfully, to these and other changes relating to international taxation. Efforts to improve supervision are beginning to produce results. Finally, tax cuts, greater efficiency in tax payment procedures, and labor market reforms to simplify hiring procedures and encourage training have improved the business climate and competitiveness, and bolstered growth prospects.

Executive Board Assessment

Executive Directors welcomed San Marino's strong economic performance and improved growth prospects, supported by a broad range of policy initiatives, which bode well for strengthening the economy's resilience. They encouraged the authorities to continue with reforms to enhance institutional flexibility and help ease the economy's transition to increased reliance on high value-adding service sectors. Directors also drew attention to the fiscal policy challenges arising from an ageing population, mobile factors of production, generous entitlements, and the need to keep tax rates competitive to attract and retain investment.

In light of ageing-related spending pressures over the medium term, Directors encouraged the authorities to take measures to stop the further reduction in the budget surplus expected over 2007–09. The tax base should be broadened further to offset the revenue losses from tax rate cuts, and current spending should be restrained further to make room for needed public investment. Transfers to public enterprises should be reduced by allowing these enterprises to operate as viable commercial entities, and, in this context, Directors supported the government's decision to increase tariffs. They also noted that healthcare spending should be further contained through demand-side measures. Directors considered that a second round of reforms in the first pillar pension system may be warranted if the fiscal position does not strengthen. They supported plans to introduce a mandatory defined-contribution second pillar pension system in 2007. While the current fiscal framework may already provide sufficient safeguards, Directors noted the authorities' intention to consider a rules-based approach to promote fiscal discipline.

The financial sector appears to be adjusting well to the new taxation and legislative regime. Directors called for an expeditious implementation of the new regulatory framework, allowing the Central Bank of San Marino (CBSM) to operate in an arms-length manner.

Directors observed that institutions in the financial sector are venturing into new lines of business with new risks, increasing the importance of adequate supervision and oversight of the sector. In this vein, the first round of in-depth examinations should be completed expeditiously. Directors recommended that the introduction of deposit insurance should await the strengthening of financial sector supervision. They welcomed the authorities' decision to participate in the Financial Sector Assessment Program.

Directors considered that maintaining competitiveness will be key to sustaining growth. To accommodate service sector demand for skilled labor, a further easing of restrictions on hiring non-residents and residency may be appropriate. Directors welcomed the improvements in the business climate, including the planned streamlining of public administration, and encouraged the authorities of Italy and San Marino to finalize the cooperation agreement between the two countries. They looked forward to further progress in adjusting San Marino's legislation to the highest international anti-money laundering standards.

Directors welcomed the improvements in fiscal, financial, and monetary statistics, and encouraged the authorities to further reduce the lags in data production and dissemination. They supported the authorities' decision to participate in the General Data Dissemination Standard.

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San Marino: Selected Economic and Social Indicators, 2001–07

	2001	2002	2003	2004	2005	2006	2007
					Est.	Proj.	
	(Annual percentage change, unless noted otherwise)						
Output and prices							
Real GDP 1/	5.5	0.3	3.9	4.6	5.0	5.0	4.9
Employment	5.5	0.7	0.5	2.8	1.2	2.8	…
Unemployment rate (end of year; in percent)	2.9	3.9	4.1	3.4	3.6	3.3	…
Inflation rate (annual average) 2/	2.8	2.3	2.5	1.4	1.7	1.7	1.5
Nominal GDP (in millions of euros)	911	935	995	1,061	1,134	1,213	1,293
	(In percent of GDP)						
Consolidated government							
Overall balance	…	0.8	5.2	3.4	5.8	2.0	0.8
Primary balance	…	1.0	5.4	3.7	6.1	2.3	1.1
Gross debt (loans)	…	5.3	4.7	5.4	4.6	3.6	3.1
	(In percent of GDP, end of period)						
Net foreign assets							
Deposit money banks	60.4	139.2	101.1	61.2	70.3	…	…
Central bank	15.2	17.1	20.0	24.5	26.4	…	…
	(In percent of GDP, unless noted otherwise)						
External accounts							
Trade balance 3/	-6.0	-9.7	-9.5	-5.1	…	…	…
Exports 3/	184.8	177.6	177.1	186.1	…	…	…
Imports 3/	191.5	187.9	185.5	190.2	…	…	…
Compensation of employees, net	9.2	9.7	9.1	8.9	…	…	…
Gross international reserves (in millions of U.S. dollars)	133.5	183.4	252.7	355.6	354.0	…	…
Number of tourists (in millions) 4/	3.0	3.1	2.9	2.8	2.1	2.1	…
Exchange rate (euros per U.S. dollar, end of period)	1.1	1.1	0.9	0.8	0.8	0.8	…
Social indicators							
GDP per capita (current US$, 2005)	37,559						
Population (2006)	30,368						
Population density (2006, persons per km^2)	496						
Life expectancy (2006)							
Male	78.6						
Female	85.5						
Literacy	96%						

Sources: Sammarinese authorities; U.S. Department of State; and IMF Staff estimates. Data for 2006–07 are Fund Staff estimates and projections.
1/ IMF staff estimates for 2005
2/ Data break in 2004. Data for 2004 onward are based on new CPI (December 2002=100).
3/ Based on national accounts data.
4/ Data break in 2005 due to change in methodology for calculation.