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

San Marino's growth momentum moderated in 2017 on the back of weak external demand and increased financial sector uncertainties, which contributed to sizable deposit outflows. Deposit outflows have abated in recent months, yet the banking system's fragilities remained elevated owing to poor asset quality, sizable capital shortfalls, high operating costs, and low liquidity. Repeated capital injections to the state-owned bank, Cassa di Risparmio della Repubblica di San Marino, contributed to persistent fiscal deficits, while a full and upfront cost recognition of past bank interventions by the state poses significant stability risks.

San Marino made progress in improving the business climate and increasing labor market flexibility, yet—absent swift and significant policy actions to restore banking system viability, support credit conditions, and mitigate fiscal risks—growth prospects are projected to remain weak. Real GDP is projected to grow by one percent on average in 2018–19, supported by exports and investment while final consumption is set to further contract as household continue to deleverage. Over the medium term, growth is projected to further moderate as the completion of the investment project in 2019 and tight credit conditions will drag down investment growth, while less favorable external conditions will lower export growth. Elevated financial and fiscal fragilities pose significant downside risks, especially given the central bank's low liquidity buffers, inadequate powers and tools, and lack of external market access.

Executive Board Assessment **[2]**

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

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

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

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

Directors stressed that addressing structural impediments and expanding market access is important to promote higher growth. They welcomed the recent measures to relax the hiring of nonresidents and underscored that further efforts to enhance the business environment, improve labor market flexibility, and close infrastructure gaps would boost San Marino's growth potential. Directors supported the authorities' efforts to increase economic integration with the European Union.

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

San Marino: Selected Economic Indicators, 2015–20

Est.

Projection

2015

2016

2017

2018

2019

2020

Activity and Prices

Real GDP (percent change)

2.5

2.5

0.6

1.1

0.8

0.7

Unemployment rate (average; percent)

9.2

8.6

8.1

8.0

8.1

8.1

Inflation rate (average; percent)

0.1

0.6

1.0

1.6

1.6

1.7

Public Finances (percent of GDP) 1/

Revenues

23.0

23.3

22.1

22.9

20.9

20.9

Expenditure

26.3

23.4

25.7

25.7

23.3

24.0

Overall balance

-3.3

-0.2

-3.6

-2.7

-2.4

-3.0

Government debt (Official)

21.8

24.0

25.9

27.5

28.8

31.0

Government debt (incl. CRSM legacy losses and tax credits)

33.5

35.2

76.6

77.0

77.1

77.9

Money and Credit

Deposits (percent change)

-6.7

-5.6

-12.3

-1.5

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Private sector credit (percent change)

-6.6

-5.1

1.1

-2.9

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Net foreign assets (percent of GDP)

182.9

161.1

138.1

133.0

…

…

External Accounts (percent of GDP)

Current account balance

…

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-0.5

0.4

0.4

0.2

Gross international reserves (millions of euros)

348.1

427.8

252.7

252.5

…

…

Financial Soundness Indicators (percent)

Regulatory capital to risk-weighted assets

12.7

11.5

13.7

…

…

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NPL ratio 2/

52.6

50.0

54.0

…

…

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NPL coverage ratio 2/

28.7

54.8

56.0

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…

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Return on equity (ROE)

-9.0

-13.2

-10.0

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Liquid assets to total assets

29.8

28.0

22.7

…

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Liquid assets to short-term liabilities

58.9

53.0

40.6

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Sources: International Financial Statistics; IMF Financial Soundness Indicators; Sammarinese authoritie

1/ For the central government.

2/ CBSM supervisory data. 2017 data do not reflect 2017 AQR results.

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

[2] 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. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm
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