



October 6, 2017

The self-inflicted pain in Spain

Up until October 1st, the threat of Catalonia splitting from Spain appeared to be receding. Most polls showed support for separation had fallen from a peak of 50% in 2013 to 35%-40%.

But images of police storming schools, taking ballot boxes and using force against voters appears to have given support for separation a second wind. Indeed, it is hard to imagine a set of images that could have done more to bolster the cause of Catalan separatism. In retrospect, the best option for the central government would have been to proclaim the vote illegal but allow it to proceed.

Despite the central government's heavy-handed measures, the separatist forces in Catalonia must overcome many formidable obstacles in order to attain their goal. These include: resistance from a large percentage of the Catalan population, opposition from the EU (including most member states), and fears of economic turmoil. Doubts over the validity of the recent referendum are yet one more barrier. All of these factors lead us to conclude that Catalan independence will not be achieved in the foreseeable future.

Referendum results

At first glance, the Catalan government's declaration that 90% of participants voted to break away from Spain on a voter turnout of just over 40% looks impressive, particularly since the federal government took significant measures to impede the process.

However, there are also valid reasons to view these figures with a healthy dose of skepticism. For starters, the polling stations were manned solely by secession supporters who were also in charge of counting the votes. The Catalan government also allowed people to print out their ballots at home and to vote wherever they wanted. This in turn has lent credence to reports of people voting more than once. Finally, well over half the electorate declined to take part in the referendum. It safe to assume that many of these people are opposed to separation.

The most extreme scenario would be for the Catalan parliament -- where a coalition of pro-independence parties ranging from the center-right to the far-left holds a slim majority -- to declare independence unilaterally. If this occurred, it would force the central government to use article 155 of the Spanish constitution to suspend Catalonia's autonomy, thereby plunging Spain into uncharted constitutional waters. **A unilateral declaration of independence would garner very little international support under these circumstances.**

Interestingly, a non-binding vote in 2014, also held in defiance of the Spanish courts, had a similar outcome. About 80% voted to leave Spain on a voter turnout of 36%. Concerns over the accuracy of the count had also been expressed at the time.

What is the European Union's position?

The EU's official position is that "this is an internal matter that has to be dealt with in line with the constitutional order of Spain." Indeed, while EU countries disagree on many subjects, they are in widespread agreement that Spain's territorial integrity must be respected. They fear an independent Catalonia would encourage separatist movements in other regions, such as Flanders in Belgium.

The EU is, however, pushing for a negotiated compromise behind the scenes. The last thing it needs is prolonged instability in the Eurozone's fourth largest economy.

Events in Spain have led to accusations that the EU employs a double standard in the treatment of countries. The EU came out strongly against the governments of Poland and Hungary for imposing political controls on the judiciary and the media. It even threatened sanctions. Yet, to date, the EU has not publicly criticized Spain for the heavy-handed tactics it employed to disrupt the vote.

The difficulty of acquiring EU membership

In order to join the EU, an independent Catalonia would have to receive a unanimous yes vote from the member states. Spain would obviously be the first to vote against. Other countries struggling with their own restive regions, such as Belgium and Italy, would very likely follow Spain's lead.

What is the potential economic impact?

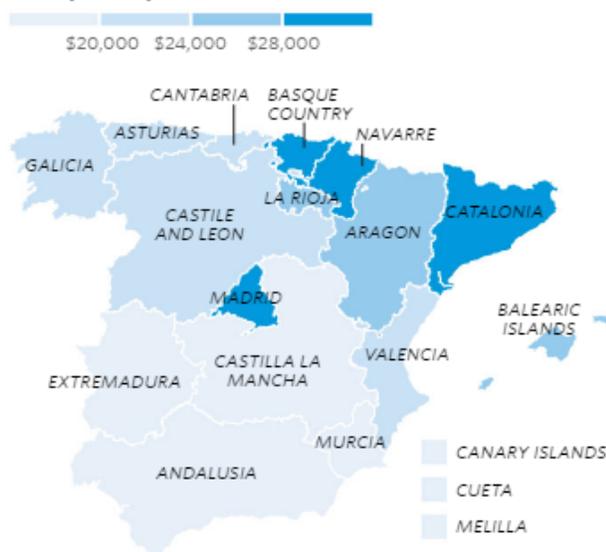
While Spain's economy has been one of Europe's best performers-3.5% and 3.3% GDP growth in 2015 and 2016, respectively-in the past few years, it still faces many challenges. These include 18% unemployment, a 100% debt-to-GDP ratio, and stagnant wages. Spain has also just returned to its pre-crisis 2007 GDP level. All of these challenges leave Spain highly vulnerable to any fallout from Catalonia, which is the most prosperous of the country's 17 regions.

Catalonia's 7.5 million people account for 16% of Spain's population and 20% of its GDP. Catalans have long complained that they give more money to Spain than they get back (the difference was \$10 billion in 2016).¹

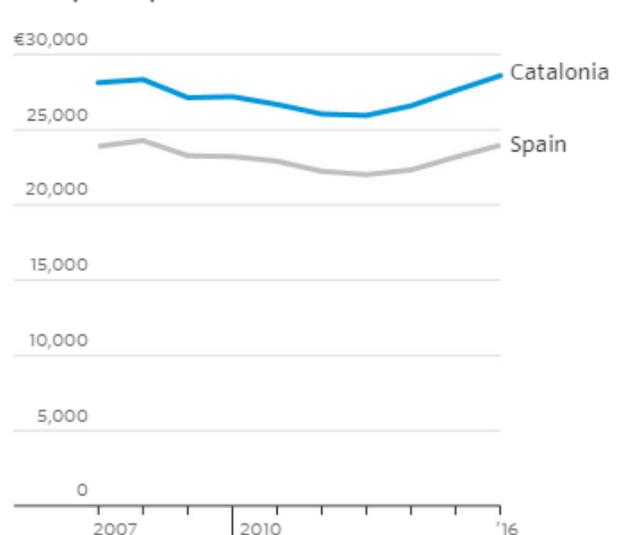
Head of the Pack

Catalonia has been an economically strong area when compared with the rest of Spain.

GDP per capita in 2016



GDP per capita



Note: €1 = \$1.18

Source: Spain's National Statistics Institute

THE WALL STREET JOURNAL

"A Majority in Spain Don't Want Catalonia, or Any Other Region, to Break Away," Wall Street Journal, September 29, 2017

On the negative side, Catalonia is also one of Spain's most indebted regions. Its debt as a proportion of GDP has more than tripled since 2009 to over 35% (or 77 billion euros).² Many argue that an independent Catalonia would have to assume a share of Spain's national debt. On top of this, there is the risk that an independent Catalonia would trigger a mass relocation of companies and people to Spain, particularly among those who identify more with the Spanish language.

Can the federal minority government survive the Catalan crisis?

There is no doubt that that events in Catalonia have weakened Prime Minister Mariano Rajoy's minority government. **What could keep the government in power in the coming months is the possibility that no party wishes to inherit the mess Rajoy created.**

If the government were to collapse, chances are it would be replaced by a left-leaning governing coalition. This in turn could lead to the reversal of many recently passed economic reforms. **This risk would be heightened by the inclusion of the far left Podemos party in the coalition.**

The next general election is officially scheduled for July 2020. However, a snap election could be called much sooner.

¹ "How Catalonia's bid for autonomy compares with other regions," The Independent, October 3, 2017

² "What an independent Catalonia could look like," The Telegraph, October 4, 2017

Conclusion: The most likely outcome

While the political climate in Catalonia is likely to get worse before it gets better, we feel that that Catalonia will ultimately not break away from Spain.

The most likely outcome is that Spain will offer Catalonia the right to keep more of its tax revenue. Opinion polls suggest that this option is supported by the vast majority of the population. Ironically, a 2010 court decision struck down parts of a law that would have granted Catalonia such powers and perhaps avoided much of this mess. However, allowing Catalonia to keep more of its taxes would mean less money for poorer regions across Spain.

If Catalonia were legally permitted to hold a referendum with all the necessary safeguards to ensure accuracy, most polls show that the majority of Catalans would vote to remain in Spain in exchange for greater fiscal autonomy. This is due in no small part to fears that separation would be followed by economic turbulence.

The Catalan question adds yet one more item to the long list of challenges already facing the EU. These include:

- Brexit negotiations
- Illegal immigration
- Growing tensions with Eastern European countries over issues ranging from state restrictions on the media and the judiciary to the resettlement of refugees
- Strong support for parties on the far right and left of the political spectrum
- Promoting further integration and economic reforms within the EU in the face of stiff public opposition
- Tense relations with Russia and Turkey
- Winding down QE without causing a devastating spike in bond yields among heavily indebted countries
- Negotiations with Greece ahead of the expiry of its bailout program in 2018

Finally, and perhaps most importantly, Catalonia's perennial complaint that it pays much more in taxes to Spain than it gets in return represents on a smaller scale EU's fundamental challenge in promoting further integration. **If one region of Spain cannot be convinced to help other regions of the country that are less well-off, imagine how much harder it will be to convince the likes of Germany and Austria to support Greece and Italy financially over the long term.**

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