

European Economics

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Catalonia's choice

Catalonia goes to the polls this Sunday and the decision to become independent from Spain is at stake. Artur Mas, Catalonia's president, has pledged to call a referendum on independence in the next legislature if his centre-right nationalist alliance is returned to parliament as the largest bloc and provided his alliance can form a majority with other pro-independence parties.

Fiscal austerity is at the root of the call for early elections and also at the root of the more secessionist fervour. Mas' goal is a fiscal pact for Catalonia rather than independence in our view. He has long sought to re-negotiate intra-regional transfers and for Catalonia to have more tax autonomy, along the lines of Navarre and the Basque country. It is interesting that Mas has expressed frustration that the central government in Madrid is not offering to negotiate.

Madrid is also playing a game of brinkmanship. Catalonia is the most indebted of the regions and is fully dependent on Madrid financing its debt. Madrid is thus in no hurry to make concessions.

A referendum on independence is banned under Spain's constitution. Mas could get around it by holding a consultation on independence but the most recent experience with Catalonia's non-binding, unofficial referenda has not been successful. Also at stake is Catalonia's membership of the EU and euro should it become independent.

We believe that it is extremely unlikely that Catalonia chooses the extreme option of declaring unilateral independence. But financial markets might need to continue putting up with secessionist noise as Mas tries to extract fiscal concessions out of Madrid following the election.

We also take a look at the economic implications of leaving Spain. Catalonia accounts for one-fifth of Spain's GDP and is Spain's wealthiest but also most indebted region. Although the region is fairly diversified, it remains heavily dependent on the Spanish market. Leaving Spain and the EU could see Catalonia's GDP decline by one-fifth in the initial years after secession according to some studies. All this is likely to be factored in should Catalan people get asked on independence.

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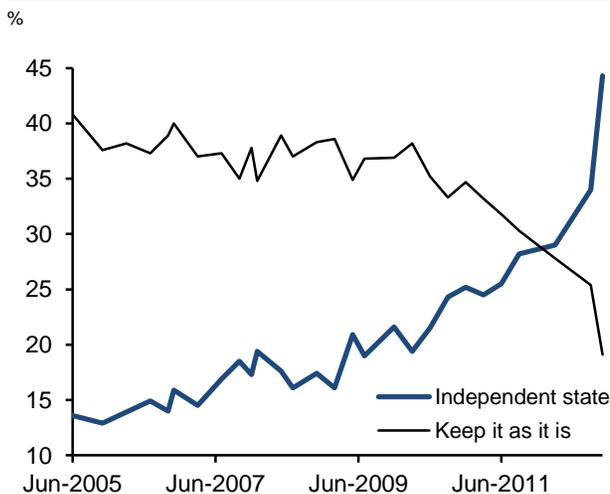
On Sunday 25 November, Catalonia goes to the polls and the decision to become independent from Spain is at stake. Catalonia's current president, Artur Mas, called the election early after Madrid refused more fiscal autonomy for Catalonia, which was followed by a large pro-independence march. Mas pledged to call a referendum on independence in the next 4 year legislature, provided his centre-right nationalist alliance (CiU) is returned to Catalonia's 135-seat parliament, as the largest bloc and provided the CiU can form a majority with other pro-independence parties.

Catalan people are increasingly in favour of independence. For the first time since 2005 a majority of Catalans would support it. Five years ago and before Spain's debt crisis only around 15% of Catalans wanted independence. Austerity has hardened attitudes especially when taking into account that Catalonia, while Spain's wealthiest, is also its most indebted region. Like elsewhere in Spain, protests have grown against cuts the regions are forced to make in education and healthcare, the two main areas regions control. And PM Rajoy's fiscal reform, which allows the central government in Madrid to intervene in finances of poorly performing regions has not been helpful.

The key is more control of Catalonia's finances. Artur Mas was never known as a convinced secessionist. But against the austerity backdrop, it is no surprise that Catalonia wants to get more of a say over its finances. Ideally, the region aspires to have its own tax agency like the autonomous regions of Navarre and the Basque country. This would allow the Catalanian government to collect taxes and send them to Madrid rather than depending on funds raised by national government taxation and budgeted to Catalonia. The aim of more fiscal autonomy is based on the argument that Catalonia pays more to the Spanish national coffers than it receives, although this argument conveniently overlooks the "solidarity between regions" enshrined in Spain's constitution.

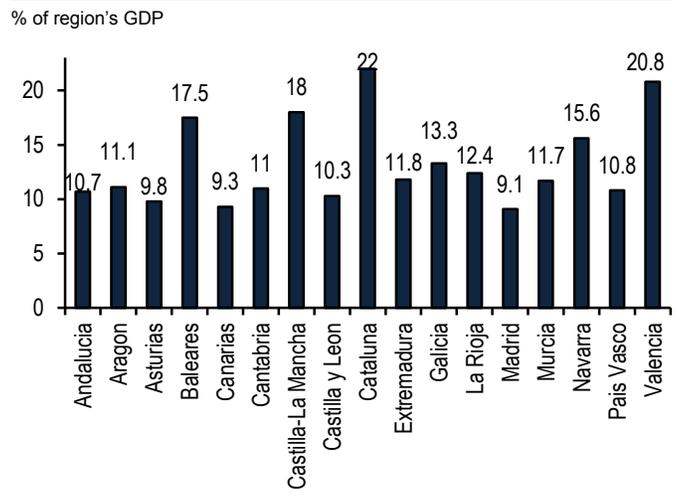
Crucially, polls also show that there would be no majority for independence if Catalonia gets more control over its finances.

Exhibit 1: Should Catalonia become independent?



Source: CEO Barometre d'Opinion Política, Credit Suisse

Exhibit 2: Regional government debt



Source: Banco de Espana, Credit Suisse

But Artur Mas is seeking negotiations. With less than one week to go before polling day he reiterates that the CiU will not renege on its promise to seek a referendum. But on the week-end he has also opened the door to talks, stating that Madrid and the Catalan government need to negotiate and that the Catalan government would be prepared to study offers. Ahead of the election, however, he is also hardening the stance, stating that the fiscal pact he sought before calling for a referendum would not be enough any longer.

Artur Mas' centre-right alliance is unlikely to achieve an absolute majority. The most recent opinion polls show that the centre-right *Convèrgència i Unió* (CiU) is likely to achieve around 37% of the vote, which would allow the alliance to hold on to its current 62 seats in the Catalan parliament. This would fall six seats short of the 68 needed to obtain an absolute majority in the 135-seat chamber. This outcome could see the CiU continuing as a minority government forging occasional pacts with other parties such as the agreement reached with the socialists back in 2010 which then gave Mas the presidency.

Mas linked majority to endorsement for a referendum. In the absence of an absolute majority he would thus have to rely on other pro-independence parties to pursue the referendum. A clear winner from the polarization of the vote along independent lines has been the strongly pro-independence Republican Left party (ERC) which could see its seats increased from 10 to 18 if the polls are corroborated, but an alliance between the centre-right CiU and the ERC only to pursue the independence vote seems far-fetched.

Exhibit 3: 2010 election results and 2012 poll

	2010 election result		2012 poll	
	% of vote	Seats	% of vote	Seats
CiU	38.2	62	37.3	62
PSC-PSOE	18.2	28	12.3	18
PP	12.3	18	13.2	19
ICV-EUiA	7.3	10	7.9	10
ERC	7.0	10	12.2	18
SI	3.3	4	1.7	0
C's	3.4	3	5.7	6
Other			3.0	2
		135		135

CiU (*Convèrgència i Unió*): Important segments of this alliance in favour of independence.

PSC-PSOE (*Partit dels Socialistes de Catalunya*): Sister party of Spain's main social democratic party, PSOE. Weakly anti-independence.

PP (*Partit Popular*): Spain's conservative party. Strongly anti-independence.

ICV-EUA (*Iniciativa per Catalunya-Verds – Esquerra Unida y Alternativa*): Initiative for Catalonia-Green – United and Alternative Left. Weakly pro-independence.

ERC (*Esquerra Republicana*): Republican Left of Catalonia. Strongly pro-independence.

SI (*Solidaridad Catalana per la Independencia*): Catalan Solidarity for Independence. Strongly pro-independence.

C's (*Ciutadans*): Party of Citizenry. Strongly anti-independence.

Source: *Metroscopia*, *El País*, Credit Suisse

The socialists are likely to be the big losers from the polarization of the vote. Following strong declines in the Galician and the Basque country elections, Catalanian polls also show that they are likely to lose a significant amount of seats in Catalonia. The Catalan socialists are divided on independence and have attempted to occupy a position between two extremes which is not paying off. The marked difference over self-rule between the socialists and the strongly pro-independence ERC is also likely to stand in the way of a revival of the tri-party alliance between socialists, ERC and the green ICV group that ran Catalonia before.

The politics of secession

A referendum on independence is banned under Spain's constitution. The central government is thus adamant that it can block Catalonia's secessionist dream. In fact, the Spanish constitution of 1978 allows for consultative referenda on "political decisions of special importance", but this requires approval of both the government and the lower house of the Cortes Generales (parliament).

And it gets more complicated. Article 2 of the constitution refers to "the indissoluble unity of the Spanish Nation, the common and indivisible homeland of all Spaniards". Catalanian independence would thus require a constitutional amendment. Article 168 ensures, that such an amendment cannot be done lightly and requires:

- A two-thirds majority in both chambers of the Cortes Generales;
- the dissolution of the Cortes Generales and a general election;
- the re-approval of the amendment by two-thirds majority in both chambers of the newly elected Cortes Generales.

Catalonia will try to hold a legal referendum but that will not be possible. For Mas, the model is the London agreement with Scotland. But this is unlikely to be granted by the conservative Spanish government which remains opposed to a referendum and which enjoys a majority in the Cortes Generales. PM Rajoy has publicly stated that his government will not authorize a referendum on Catalan independence.

Catalonia could then try to get around the constitution by holding a consultation. Under Catalan law, a consultation on independence is not regarded as a referendum. But the government in Madrid has already threatened to appeal to the Spanish constitutional court to obtain a suspension of this law. The Spanish foreign minister has even gone further, equating such a consultation to a Catalan 'coup d'état'. The option for Mas could be to hold a non-binding, unofficial referendum and hope that a high turnout and positive vote in favour of independence puts pressure on Madrid. But the most recent experience with such non-binding unofficial referenda has not been successful. In autumn 2009 a series of non-binding, consultations started being held in municipalities around Catalonia with polling planned to encompass all the municipalities in the region. Many separatist organisations supported the consultations and the result was an overwhelming yes to independence in those municipalities that voted, but the very low turnout of less than 30% led to the consultations being aborted.

Also at stake is Catalonia's membership of the euro area and EU. Here the government in Madrid has been backed by the EU. In a letter to the Spanish government, the vice-president of the European Commission, Viviane Reding, stated that an independent Catalan state would have to submit an application for membership. This application in turn needs to be approved by all member states unanimously and it is clear, that the current Spanish government would not back this. An exclusion from the EU and euro area would have dramatic economic consequences for Catalonia. Following the letter Mas' tone moderated initially when he stated he would be prepared to rethink the plan to seek independence if it becomes clear that a new Catalan state would be excluded from the EU. Since then, and in the run-up to the election, his tone has, however, become less conciliatory once more.

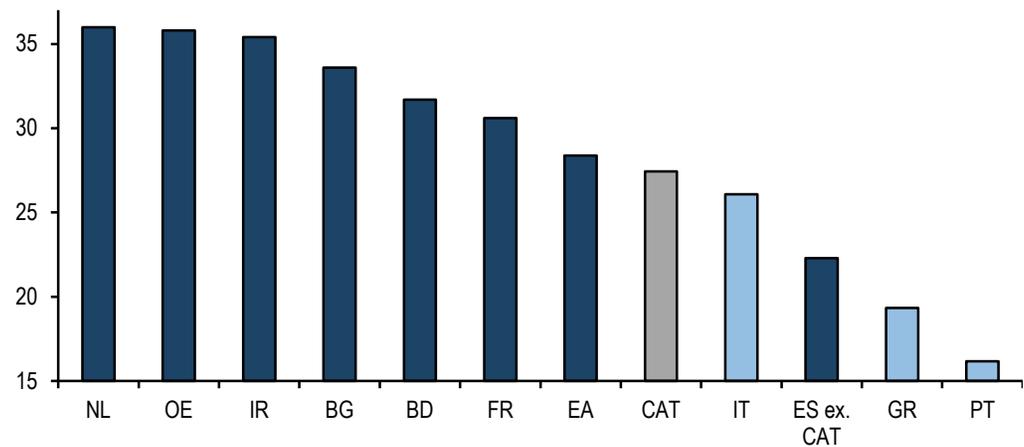
The economics of secession

Catalonia accounts for one-fifth of Spain's GDP. Although it comes only sixth among Spain's regions when it comes to area, this area is equivalent to the size of Belgium. It is the second most populous Spanish region, equivalent to the population of Switzerland. Comparing to euro area countries, the Catalan population is 40% and one-third larger than those of Ireland and Finland respectively.

It is Spain's wealthiest region. Catalonia's GDP per capita is only marginally below the euro area average, and one-fifth above the per capita wealth of the remainder of Spain.

Exhibit 4: GDP per capita

In EUR 000s, 2011 data



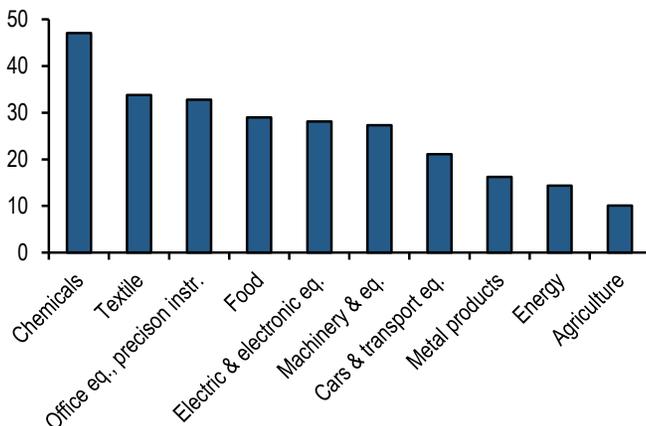
Source: Datosmacro.com, Credit Suisse

Catalonia's economy is fairly diversified. It accounts for nearly half of Spain's chemical exports and roughly a third of Spanish exports beyond food and textiles such as machinery and equipment. With a large German car brand operating a subsidiary in Catalonia, the region also accounts for one quarter of Spain's car and transport equipment exports.

But Catalonia is not self-sufficient, it needs Spain when it comes to trade. Although at 14% its French neighbor accounts for the largest share of Catalonian exports, ten out of its fifteen key trading partners are Spanish regions. The latter account for more than 60% of its total sales.

Exhibit 5: Catalonia's contribution to Spain's exports

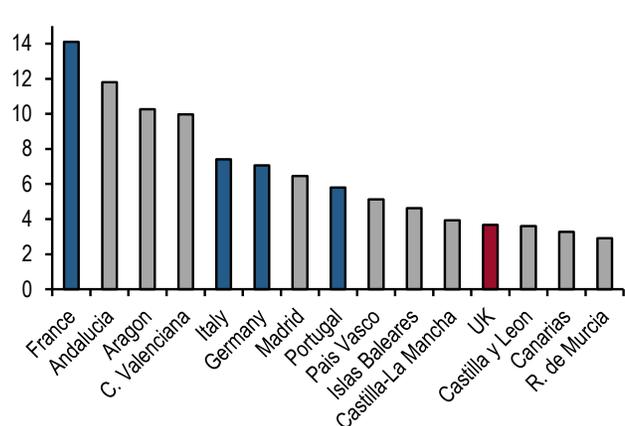
% of Spanish exports



Source: Institut d'Estadística de Catalunya, Credit Suisse Locus

Exhibit 6: Catalonia's key export markets

% of total

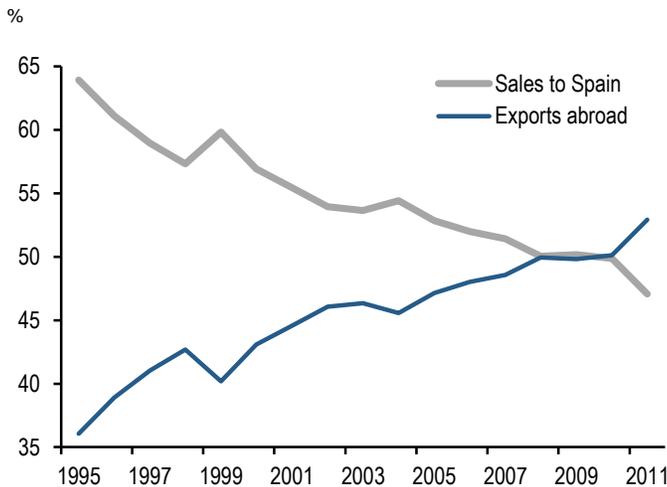


Source: Convivencia Cívica Catalana, C-interreg Ceprede, Credit Suisse

Mr. Mas has been happy to downplay the dependency on Spain, highlighting the fact that last year and for the first time Catalonia's exports to the rest of the world exceeded sales to Spain. In the mid-1990s sales to the rest of Spain accounted for more than 60% but this share has been declining steadily.

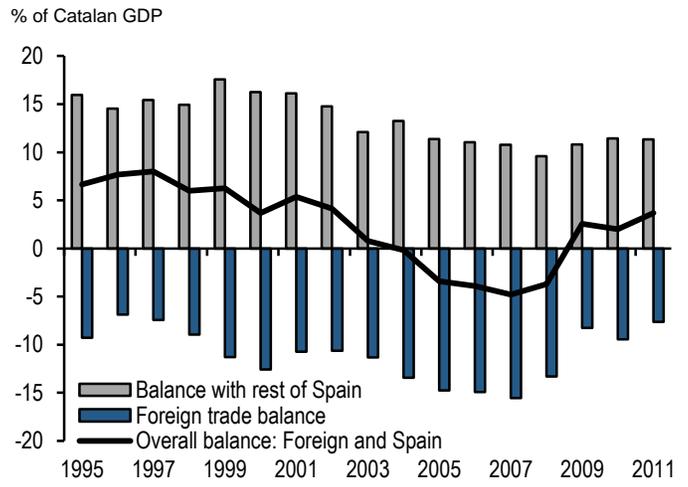
But looking only at exports is misleading. Catalonia remains heavily dependent on the Spanish market. Although Catalonia has steadily exported more goods abroad, its trade balance with the rest of the world remains negative to the tune of nearly 8% of Catalonia's GDP. Partly, this is because many of its exports, such as cars, assemble parts which need to be imported. Catalonia's goods trade balance only becomes positive once net sales to Spain are taken into account. With Spain, Catalonia's goods trade surplus amounts to 11% of its GDP.

Exhibit 7: Share of Catalan sales



Source: Institut d'Estadística de Catalunya, Credit Suisse

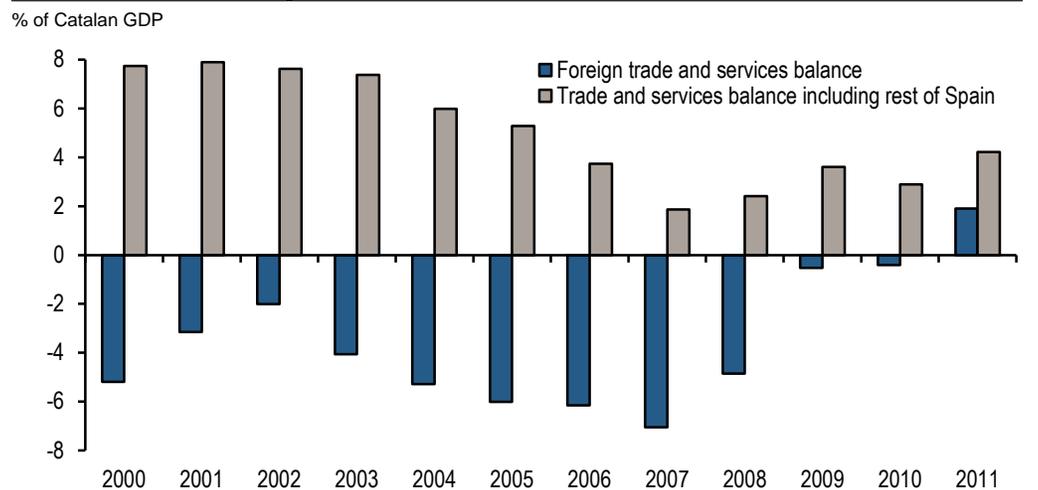
Exhibit 8: Trade balance of goods



Source: Institut d'Estadística de Catalunya, Credit Suisse

Catalonia's total trade balance, which also includes services, has only been in surplus thanks to its trade with Spain throughout the last decade. Only last year, and for the first time, its foreign total balance also managed to register a surplus. This was largely thanks to tourism, with foreigners increasing their spending in Catalonia by nearly 15% over the last two years while Catalonians are reigning in their spending abroad.

Exhibit 9: Catalanian goods & services balance



Source: C-intereg Ceprede, Credit Suisse

Spain is a key trading partner and this is not surprising. Studies which have tried to assess the so-called border effect find that even if countries are part of a trade union such as the EU and there are no trade tariffs, political borders still matter. French regions trade eight times more with each other than with the rest of the EU while it is three times as much in the case of the German states.

Separation cuts trade significantly. Studies that have reviewed separations such as that of the Czech and Slovak Republics or Slovenia and Croatia find that in all cases trade between formerly united countries falls by between one and two thirds in the initial years following separation.

The decline would be compounded by Catalonia having to leave the EU. Catalanian trade would be subject to increased transaction costs and tariffs. An EU exit would also prompt some companies currently based in Catalonia to relocate. Out of the ten largest companies by transaction volume based in Catalonia, two have publicly stated that they would relocate to Spain if Catalonia would become independent and had to leave the EU. One of those companies currently accounts for 5% of Catalan employment. Research carried out on behalf of the Institute for Fiscal Studies looked into Basque separatism and estimated that in the Basque case, the effect of relocation would result in a decline of nearly 7% of Basque GDP.

Catalonia's GDP could decline by one-fifth according to estimates of a Catalan study. The study adds up the estimated decline of trade with Spain, higher transaction costs and tariffs, the negative effect stemming from the relocation of key companies and the detrimental effects all this would have on Catalan household spending and investment. A 20% fall in Catalonia's per capita income would leave Catalonia falling below the wealth level of the remainder of Spain. And this is not taking into account the likely effects coming from capital flight, financial instability and the introduction of a new currency. While Catalonia would not have to make fiscal transfers to Madrid any longer, a new state has to establish services such as defense, security and diplomacy currently enjoyed as being part of the Spanish state. As a result, and to start with other studies estimate an even higher decline in Catalanian wealth.

Conclusion

Fiscal austerity is at the root of the call for early elections and also at the root of the more secessionist fervour. Voters feel they would be better off if they were not part of Spain and that has prompted a surge in national sentiment and anger at Madrid's perceived power grab.

Mas' goal is a fiscal pact rather than independence in our view. He has long sought to re-negotiate intra-regional transfers and for Catalonia to be able to set up its own tax agency along the lines of Navarre and the Basque country. Behind his call for independence is thus political opportunism and he has already expressed frustration that the central government in Madrid is not offering to negotiate given his call for a referendum.

An absolute majority for the CiU would strengthen Mas' hand when. He could then attempt to get more concessions by using the independence card more strongly. The most recent opinion polls, however, indicate that he might fall short of securing the absolute majority, but there is still a large, nearly one-third, of undecided voters.

Madrid is also playing a game of brinkmanship. With Catalonia being the most indebted of Spain's regions and Catalonia fully depending on Madrid to finance this debt Madrid feels that it does not need to make concessions in a hurry. Increased transfers to Catalonia might be in the pipeline, however. The financing system of the autonomous regions is reviewed every five years. The last revision was done in 2009 so the next one is not due until 2014. But the government has already stated that it would bring the review forward into next year. As in 2009, when Catalonia got a larger share of taxes raised in the region a further increase should not be excluded. Increased transfers could deflate some of the nationalist zeal.

A reform of the financing of the regions which could bring about a more federal system is required in the view of some of the Madrid government's politicians. But such a reform is unlikely to be attempted in the current legislature with the government's hands full trying to comply with deficit targets and implementing an array of structural reforms to make Spain's debt more sustainable and the economy more flexible and competitive.

Secession is strongly opposed by the conservative government in Madrid. All legal levers will be used to prevent a referendum. Should Catalonia persevere, the extreme case would be an illegal consultation followed by a unilateral declaration of independence. But given the economic costs resulting from remaining outside the EU and euro area a 'yes' to independence should not be a foregone conclusion. And even if Catalonia would hold on to the euro and not create a new currency from the outset, Catalanian banks would not have access to the ECB and there would be no protection from the ESM for this highly indebted region. **It is thus extremely unlikely that Catalonia chooses the extreme option of declaring unilateral independence.**

But financial markets might need to continue putting up with secessionist noise as Mas tries to extract fiscal concessions out of Madrid following the election.

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