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“Catalonia, a New State within Europe”?

“Catalonia, a new state within Europe” is the slogan of the pro-independence secession movement in the Spanish region of Catalonia. Catalonia has always pined for more autonomy, but calls for secession have intensified as the Spanish economy has suffered from slow growth and corruption scandals have discredited the central government. At the end of September, Catalonia held regional parliamentary elections. These elections were touted by some as a prelude to Catalan secession from Spain. However, the Spanish federal government has made it clear that it will not hold negotiations for secession and, in fact, even holding an independence referendum is considered unconstitutional. Although the majority of Catalans support independence, they could likely be appeased with more autonomy, especially financial autonomy.

This week, we will look at the separatist movement in Catalonia. We will start by giving a brief overview of the region’s history and politics, then look at the roots of the independence movement. We will explore the probability of independence, the potential future relationship between the region and the central government, and the roles of the EU and the Eurozone. As always, we will conclude with market ramifications.

The Region of Catalonia

Catalonia, one of the country’s 17 districts, is located in the northeastern region of Spain. The regional capital of Catalonia is

Barcelona. Catalonia’s population of 7.5 mm makes up 20% of Spain’s population, and the region accounts for 25% of the country’s economy. Catalonia has a distinct language and culture from the rest of Spain. It is also one of the country’s richest and most industrialized regions, accounting for around 20% of its tax revenues.



(Source: www.maps.com)

Prior to the 15th century, the region was an independent country, until King Ferdinand of Aragon and Queen Isabella of Castile married and formally united Catalonia with Spain. Even after the two courts merged, Catalonia maintained its own institutions, remaining an effectively independent nation. In 1714, during the war of Spanish secession, the Spanish army formally conquered the region. Catalans are proud to mention that it took the combined Spanish and French armies a full year to conquer Barcelona. The Catalans have never forgotten that they were conquered by Spain, with some pro-independence politicians pointing out that the region never

chose to be part of Spain. To this day, Catalans commemorate the day that Barcelona fell in 1714 as the National Day of Catalonia. On this date in 2012, more than two million people marched in support of independence.

When the Spanish monarchy was replaced with a democracy in 1931, Catalonia was given broad autonomy, with its own regional president and government that reported to the central government in Madrid.

The Spanish Civil War (1936-1939) and the ensuing dictatorial rule of Francisco Franco was ruthless for all of Spain, but was especially brutal in Catalonia. The region was a Republican stronghold against Franco's army, which resulted in heavy bombing of its cities, especially Barcelona. Franco's ultra-conservative rule revoked any independence that the region had enjoyed. The dictatorship also attempted to suppress the Catalan identity, restricting the public use of its language, Castilian.

Following the death of Franco in 1975 and the democratization of Spain, Catalonia was granted its own regional parliament but was still required to send its revenues to the central government in Madrid.

The Call for Independence

Calls for Catalonia's independence are based on a variety of issues, but the two key disputes are cultural and economic.

Culturally, Catalonia has a separate identity and language from Spain. Catalan culture is markedly different from Spanish culture. The population views itself more akin to the Catalan regions of France than to the rest of Spain. As noted above, the region was independent until the 15th century and has sought to return to independence ever since. Catalans believe that when Spain became

democratic in 1931, the central government granted the region certain freedoms that started the process toward full independence.

The oppression of Catalan culture and language during Franco's dictatorial rule only further boosted the aspirations for autonomy. Additionally, when the current central government tries to tighten its control over Catalonia, the regional communal psyche assumes that any central control will be as repressive as Franco's regime.

Economically, the pro-independence movement has been fueled by the perceived unfavorable tax outflows of Catalonia. Tax revenues from Catalonia have historically been larger than the funding received, subsidizing poorer regions of the country and funding central government spending priorities. Since 1986, an average of 9% of Catalonia's annual GDP has been redistributed to other regions, according to the separatist movement. Catalans have never been happy about this, but they tolerated it when the Spanish economy was growing; however, now that economic growth remains challenged and the unemployment rate is over 22%, the tax subsidies are becoming a major issue.

Most recently, pro-independence sentiment was reignited by the hardship caused by the Eurozone crisis. In 2012, Catalonia voted for a pro-independence party during a snap election, which put a separatist coalition in power. The independence ambition was further boosted after Madrid refused to renegotiate a fiscal pact in which Catalonia sought to have more independence over its finances.

The central government's budget decisions are often criticized by the regional

governments as not serving the interests of the regions funding the central budget. One of the most oft-cited examples is the mal-investment in infrastructure spending. Spain is the fifth largest EU member state by population and GDP, but it has more international airports and more miles of motorways than any other continental European country. It has more miles of high-speed rail than any other country in the world except China; however, it has the lowest ridership per mile in the world. Additionally, more miles of high-speed rail are currently under construction in Spain than all other European countries combined.

Economically, a separate Catalonia would be richer, but more indebted, than the rest of Spain. Based on GDP per capita, Catalonia would rank higher than Italy, while the rest of Spain would rank closer to Greece.

Catalonia and Spanish Federal Politics

The Catalan secession movement has coincided with the trend of rising anti-establishment political movements in Spain and Europe, in general. Thus far, the populists and secessionists have been in a union of convenience as they battle against the ruling establishment party. However, the populist party, at its core, does not necessarily support Catalan independence. At the same time, the federal establishment political parties have also supported the Catalan secession movement more than usual in an attempt to overcome the increasing populist movement.

The Catalan regional parliamentary elections in September had an unprecedented turnout, with the main pro-independence party receiving 48% of the votes. Although the party received the most votes, the independence cause seems to be losing some traction. By comparison, the referendum in

2014 revealed that over 80% of voters would like to see an independent Catalonia.

Roles of the EU and Eurozone

The EU and the Eurozone govern European monetary policy and have become more important in deciding intra-union subsidies than the governments of the individual countries. On a purely financial basis, it would currently be more beneficial for Catalonia to “cut out the middleman” of Spain and have direct representation in the EU.

However, if Catalonia were to secede, it may have to leave the Eurozone, as well as the EU, and reapply for membership as an independent country. The EU has no plan of action for countries that decide to split or leave the Eurozone. So far, the monetary union has not had to deal with a country or region’s departure from the union. If a country were to leave, this would set a precedent and it could mean that other countries might also take the same route. In fact, it is in the Eurozone’s best interests to make secession difficult in order to discourage others from leaving. So far, the Eurozone has indicated that a new Catalan state would have to apply for membership.

Even during a temporary Catalan separation from the Eurozone, the new country would not be able to use the euro. Instead, it would issue its own currency, an additional cost of separation.

Another issue is that although the region is economically vibrant, its government remains highly indebted. Catalonia would have a 94% debt-to-GDP ratio, while the remainder of Spain would have a ratio of 79%. If Catalonia were to leave the Eurozone, even temporarily, it would need to build up reserves in order to service its debt in the absence of Eurozone funding. It

is also not certain what credit rating, and thus interest rate, the region would have, but its bond yields would undoubtedly rise.

Interestingly enough, according to polls, most Catalans support holding the referendum, but are divided on their support for full independence. Before the EU indicated that a new Catalonia would not automatically remain in the EU, 47% of the Catalan population supported independence; however, this number fell to 38% after the EU announcement.

Likelihood of Independence

Catalonia is in a politically tough position. It is not constitutionally allowed to secede. However, its political parties have continued to lobby for secession on the back of popular support. The regional government even held a referendum, albeit a non-binding one, for independence, despite the federal government's reminders that the region will not be allowed to secede.

Overall, it is unlikely that Spain would allow Catalonia to secede. Even if Catalonia is able to demonstrate over-arching support for independence, it lacks constitutional support and, currently, the federal government is not open to negotiations. Catalonia would be left with forcible secession, which could lead to open conflict. Neither side is looking for a military conflict.

Another option for Spain would be to grant Catalonia more autonomy without full independence. The independence movement is partially fueled by unaddressed

dissatisfaction with the central government as political negotiations have broken down. The most likely outcome would be that Catalonia gains some autonomy, especially with regard to fiscal management. Its cultural differences have developed over thousands of years and will be near-impossible to reconcile, thus parts of Catalonia will always contemplate secession on cultural grounds. However, additional fiscal and economic autonomy is likely to placate the independence movement. America fought a civil war over similar disputes of state vs. federal rights. Other regions of the world have seen similar secessions due to ethnic, cultural, socioeconomic or political differences.

Ramifications

Catalan independence remains highly unlikely, thus markets have largely ignored its effects. However, such an event could be more significant than currently estimated. Catalonia's secession from Spain would lead to the new country's expulsion from the EU and the Eurozone. The EU does not want to set a precedent of a country leaving the union. The main market risk following the formation of a new country would be that other EU regions could follow suit, possibly leading to an EU devolution. Volatility in European equities could pick up in the short term, mostly affecting Spanish markets, and the euro could suffer outflows due to rising uncertainty.

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