

October 6, 2014

Welcome to the World, the Country of Catalonia?

On November 9, the Catalonia region of Spain is due to hold a referendum for independence. The referendum had previously been approved by the regional government; however, it was ruled unconstitutional by the Spanish Supreme Court. Currently, it is unclear whether the November 9 referendum would result in a different outcome.

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 role 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 16% of Spain's population, while the region accounts for over 18% of the country's economy. Catalonia has a distinct language and culture from Spain. It is also one of Spain's richest and most industrialized regions, accounting for almost 20% of Spain's tax revenues.



Source: www.polgeonow.com

Prior to the 15th century, when King Ferdinand of Aragon and Queen Isabella of Castile married and formally united Catalonia with Spain, the region was a fully independent country. 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 and merged with Spain, with some pro-independence politicians pointing out that the region never chose to be part of Spain. Not surprisingly, to this day, Catalans celebrate 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 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 Spaniards, 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.

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

The Call for Independence

The 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.

As an interesting aside, the recent political discourse between Catalonia and the central government in Spain mimics that of the soccer stadium atmosphere before a Real Madrid vs. FC Barcelona game (Real Madrid is based in Madrid while FC Barcelona is based in Catalonia). The dispute over independence goes back further than the soccer rivalry, but both are highly emotional causes.

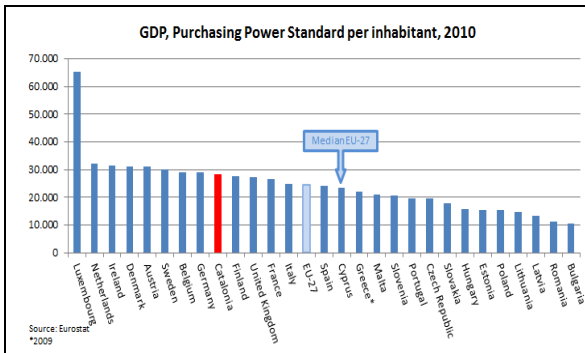
Economically, the pro-independence movement has been fueled by the perceived unfavorable tax outflows of Catalonia. Tax revenues from Catalonia have historically been larger than the funding received, subsidizing poorer regions of the country and funding central government spending priorities. Since 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 it, but they tolerated it when the Spanish economy was growing; however, now that economic growth remains challenged and the unemployment rate is at 25%, the tax subsidies are becoming a major issue.

Most recently, the 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 under 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 than any other country 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. The chart below shows GDP per capita of an independent Catalonia, Spain ex-Catalonia, along with various other European nations.



Role of the EU and Eurozone

The EU and the Eurozone govern monetary policy and have become more important in deciding intra-union subsidies than the governments of the individual countries. It is easy to see that it would currently be more beneficial for Catalonia to control its own fiscal policies 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 even leave the Eurozone. So far, the monetary union has been able to avoid a country or a region leaving 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 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 79% ratio. If Catalonia would have to leave the Eurozone, even temporarily, it would need to build up reserves to be able 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.

Catalonia's Options

Given that Spain's Supreme Court has denied the referendum's legality, the Catalan regional government has three options going forward.

First, and most likely, the Catalan government may call early elections, hoping that an election victory would give the independence cause renewed momentum by demonstrating to Madrid the strength of the separatist movement. Whether this would change anything is not clear as Madrid has been unyielding in its negotiations with the region.

Second, the regional government could still hold the referendum, albeit illegally. The central government has indicated the results of any such vote would not be recognized. Holding a referendum under such circumstances would be political suicide for the current minority government.

Third, the Catalan government could slowly bow to the pressures from the central government and give up on its independence aspirations. This is unlikely without a political and fiscal compromise from Madrid.

Overall, it is unlikely that Spain will allow a Catalan referendum, and without constitutional support, Catalonia would not possess the right to vote to become independent. It would be left with forcible secession, which could lead to open conflict.

Ramifications

The independence movement is not likely to subside in Catalonia. The identity politics have remained in place for centuries and are unlikely to change. At the same time, Spain's central government has not shown any willingness to make concessions over fiscal policies.

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. First of all, secession via a referendum can only take place when the controlling country allows the vote to take place. Westminster allowed Scotland to hold a referendum, which eventually led to a "no" vote, but the U.K. was also willing to agree on fiscal and political compromises if Scotland stayed in the union. Madrid has denied Catalonia the right to hold a referendum and has not been willing to make concessions. Catalonia and Spain seem to be at a stalemate. Secondly, other regions that have successfully separated were able to do so due to strong international support. For example, Kosovo was able to secede from Serbia due to support from the U.S. Catalonia does not currently have such a sponsor.

Markets have generally overlooked the risks arising from a Catalan secession, partly because the likelihood of such an event is still remote. Geopolitical risks could arise, but financial market risks are still limited. 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. The euro could suffer if funds flow out of the region on uncertainty. However, the euro currently has more prominent factors pressuring it lower, such as the dovish ECB monetary policy, so the effect of a Catalan referendum would likely be small.

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