

*November 6, 2017*

## **The Situation in Catalonia: Part I**

On October 27, Spanish Prime Minister Mariano Rajoy triggered Article 155 of Spain's constitution. This allowed him to dissolve the Catalan Parliament, also known as the Generalitat, and hold new regional elections on December 21, 2017. Tensions between the Catalan government and the Spanish government reached a boiling point following the Catalan government's decision to hold an illegal referendum for Catalan independence on October 1.

On the day of the referendum, Prime Minister Rajoy ordered the national police and the civil guards to close polling stations by any means necessary. Images of the violent clashes between voters and Spanish authorities circulated around the world, without denouncement from the European Union. Following the results of the referendum, in which the Catalan government claimed that 90% of Catalans voted to leave Spain, Catalan President Carles Puigdemont vowed to begin the process of Catalan secession. Spanish equity markets have been volatile since the referendum, but have recently calmed after an agreement between the Catalan political parties to take part in the new election.

In Part I, we will discuss the history of Catalonia. We will give a broad overview of how the Spanish state was created, look at its history under Spanish rule and close with a summary of the revival of the Catalan independence movement. Next week, in Part II, we will look into the current constitutional crisis as a result of the

referendum and conclude with market ramifications.

### **War of Spanish Secession**

The push for Catalan independence dates back to the 18th century when Charles II of Spain died without a direct heir to the Spanish throne. The two contenders for the throne were Philip V of the House of Bourbon, grandson of King Louis XIV of France, and Archduke Charles of the House of Habsburg, son of Emperor Leopold of Austria. Originally, there was an agreement between France, the Dutch Republic and England to give Spain to Archduke Charles of Austria, but it was never finalized because Leopold did not agree with the terms of the treaty. Charles II died before a compromise could be struck, but he granted the Spanish throne to Philip V in his will. While France immediately recognized Philip V as the rightful heir to the throne, the Dutch Republic, England and Austria objected. Because the House of Bourbon represented the French authority, Philip V's ascension to the Spanish throne would have merged two large empires in Europe. Fearing that the merger represented a threat to the balance of power in Europe, the Dutch Republic, England and Austria declared war on France and Spain in 1702 in the War of Spanish Secession.

At the time, Spain was a dynastic union between two crowns,<sup>1</sup> the Crown of Castile

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<sup>1</sup> A crown is a medieval state formed through the unification of smaller kingdoms to form a larger kingdom.

and the Crown of Aragon.<sup>2</sup> Although the two crowns were ruled by King Charles II, their governments were structurally different. The Crown of Castile was consolidated into a centralized government under the Spanish monarchy, while the Crown of Aragon was a confederation of sovereign states that pledged allegiance to the Spanish monarchy. In other words, regions within the Crown of Aragon had more autonomy and were not directly ruled by King Charles II. When the War of Spanish Secession broke out, the two crowns allied with opposing sides. The Crown of Castile pledged allegiance to Philip V, while the Crown of Aragon pledged allegiance to Archduke Charles. Catalonia was part of the Crown of Aragon along with Valencia, Aragon, Mallorca and Sardinia.<sup>3</sup>



(Source: Wikiwand.com)

Despite several early defeats from forces loyal to the Archduke Charles, the Crown of Castile continued to support Philip V. As a result, Philip V became increasingly enchanted with the Crown of Castile and spiteful to the people in the Crown of Aragon. Following the defeat of the

<sup>2</sup> The two crowns united in the 15<sup>th</sup> century with the marriage of King Ferdinand of Aragon and Queen Isabella of Castile.

<sup>3</sup> Sardinia is now an autonomous region of Italy.

Archduke Charles loyalists, Philip V issued the decrees of Nueva Planta in 1707 and 1716. Through these decrees, the Crown of Aragon was forced to incorporate into Castilian society. As a result, sovereign states lost their autonomy and were forced to speak only Castilian (now known as Spanish) and conform to Castilian law. In addition, most non-Castilian institutions were abolished.

### Centralized or Decentralized?

Because Catalonia was the last region to surrender to the Spanish throne, Philip V viewed Catalans with disdain.<sup>4,5</sup> Following Catalonia's defeat in the Siege of Barcelona in 1714, Philip V had Catalan rebel leaders executed. In order to enforce the decree, Catalonia was placed under military-based rule, in which they had to pay for the military officers' lodge and wages. In addition, Catalans were not allowed to serve in the army and were not granted senior roles in public service. At the same time, Catalans were granted access to the Crown of Castile's trade routes, which allowed them to export goods internationally. Access to these foreign markets allowed them to expand their industrial capacity and grow their economy.<sup>6</sup>

Following the overthrow of the Spanish monarchy in 1868, people of the Crown of Aragon were given a larger role to form a government after attempts to establish a new monarchy failed. The ruling class, who referred to themselves as Republicans, decided to form the First Spanish Republic that would give powers to various regions

<sup>4</sup> Harris, S. (2014). *Catalonia Is Not Spain: A Historical Perspective*. 4Cats Books. (Chapter 16).

<https://www.barcelonas.com/nueva-planta.html>

<sup>5</sup> Gagnon, A.G. (2010). *The Case for Multinational Federalism: Beyond the all-encompassing nation*. New York, NY: Routledge. (p. 16).

<sup>6</sup> Ibid.

throughout Spain. In-fighting between factions within the Republican Party prevented Spain from establishing a stable republic. Due to this turmoil, the country restored the original monarchs back into power in 1875. Following another coup in 1929, the Second Republic was established and it gave Catalonia the autonomy it had desired. This respite from central authority ended in 1939, after the Spanish Civil War, when General Francisco Franco became dictator.

The collapses of the first and second republics are viewed as defining moments for the Catalan independence movement. Although these experiments failed, they helped Catalans realize that they were capable of being independent. As a result, Catalans became more prideful of their heritage.<sup>7</sup>

### **Francoist Period**

The Spanish Civil War (1936-1939) and the ensuing dictatorial rule of Francisco Franco was ruthless for all of Spain, but was especially brutal for 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 during the Second Republic.

During his reign, Franco created a centralized and homogenized society, in which everyone had to speak Spanish and subscribe to the official religion, Catholicism. Other languages and cultures were banned. Catalonia and the Basque Country routinely rebelled against the Franco regime but were consistently suppressed.

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<sup>7</sup> Ibid.

Following the death of Franco in 1975, Prince Juan Carlos, a descendant of Philip V, ascended to the throne and established Spain as a constitutional monarchy.

### ***Café Para Todos (Coffee for All)***

Upon taking power, King Juan Carlos moved quickly to establish a new republic that would be more inclusive of the different regions of Spain. In 1978, the constitution established 17 autonomous communities and two enclave cities, Ceuta and Melilla. Each autonomous community was given its own elected parliament and was allowed to control its educational, health and cultural institutions. The central premise that all of the autonomous communities would receive relatively the same powers to govern themselves became known as “café para todos” or “coffee for all.” This approach of giving each region autonomy was wildly popular, especially among Catalans.<sup>8</sup> Despite believing itself to be a nation within Spain (à la the U.K.), Catalans voted overwhelmingly to support the constitution, garnering 91.1% of the vote with 67.9% turnout.<sup>9</sup>

Since the passage of the Spanish constitution in 1978, the Catalan government has sought to increase its autonomy. They argue that unlike other autonomous communities they are uniquely a nation and therefore should have relatively more power. Under the Spanish constitution, historical regions are given preferential treatment.

In 1979, the Catalan government was allowed to establish Catalan as its primary language and have its schools taught in Catalan, with Spanish taught as a foreign language. This led to a resurgence of the

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<sup>8</sup>[http://www.elmundo.es/especiales/2005/06/espana/estatutos\\_autonomia/historia.html](http://www.elmundo.es/especiales/2005/06/espana/estatutos_autonomia/historia.html)

<sup>9</sup>[https://elpais.com/elpais/2017/09/25/inenglish/1506339116\\_980655.html](https://elpais.com/elpais/2017/09/25/inenglish/1506339116_980655.html)

Catalan language and an increase in Catalan identity. As this identity took root, many Catalans began to resent the fact that their tax dollars were being used to help other struggling areas within Spain.

### **Time to Change the Statute?**

In 2003, Jose Luis Rodriguez Zapatero, then a candidate to become prime minister, promised to support any amendment to the Spanish constitution regarding the statute of Catalan autonomy. This promise would soon pay dividends as he sought the support of smaller parties in order to form a government after the 2004 election. Two years later, a revision to the statute that granted Catalonia semi-autonomous powers passed through parliament and was ratified by the Catalan public via referendum. It is worth noting that although the statute received 77% of the vote, the turnout was less than half of the population, suggesting that for the most part Catalans may have been indifferent to the measure at the time.

The new statute granted Catalonia more authority over its taxes and also included language referring to itself as a nation. The statute was controversial as critics, such as the right-wing People's Party (PP), claimed that it was unconstitutional and could lead to the breakup of Spain. Following the passage of the referendum, the PP filed an objection with the Spanish Constitutional Court. In 2010, the Spanish Constitutional Court overturned 14 articles of the constitution and had 27 articles reinterpreted. In addition, the court ruled that Catalonia's reference to itself as a nation had no legal validity. It was this court ruling that is considered the major tipping point for the surge in separatist support.

### ***Cafè Per a Nosaltres (Coffee for Us)***

Despite the improved relationship between the central government and Catalonia

following the death of Franco, Catalans remained reluctant to proclaim themselves as part of the Spanish state. This became apparent during the financial crisis as the unemployment rate soared and the government deficit widened in Catalonia. The pain only got worse when Spain accepted a bailout, forcing the Catalan government to accept austerity measures. In 2012, the Catalonia debt burden was so large that it was shut out of debt markets and forced to request an emergency loan from the central government.<sup>10</sup> In order to relieve pressure due to criticisms of mismanagement of funds, the Catalan government directed the blame at having to pay too much of its tax revenue to the central government. As a result, secessionist sentiment began to steadily increase from a range of 15-20% pre-2009 to an all-time high of 48.5% in 2011.

Resentment of lost tax revenue has led many Catalans to demand greater financial autonomy from the Spanish government. Catalonia points to the fact that it pays about €10 billion (\$12 billion) more in taxes than it gets back, while Andalusia, another autonomous community, receives almost €8 billion (\$9.5 billion) more than it pays.<sup>11</sup> In addition, Catalans believe that they deserve the same tax autonomy that the Basque Country enjoys. The Basque Country collects its own taxes and gives the central government only 10%.<sup>12</sup>

### **New Day, New Referendum**

The Constitutional Court's decision is cited by many as the root cause of the modern

<sup>10</sup><http://www.nytimes.com/2012/08/29/business/global/catalonia-asks-spanish-government-for-emergency-funds.html>

<sup>11</sup> <https://www.reuters.com/article/us-spain-politics-catalonia-tax/from-new-tax-office-catalonia-hopes-to-grab-billions-from-madrid-idUSKCN1BW10A>

<sup>12</sup> <http://www.economist.com/node/12501023>

Catalonia independence movement. The court decision came at a time when many Catalans were really feeling the pinch of the financial crisis. As a result, many Catalans saw the court ruling as evidence that the Spanish government is not concerned with the people of the region. The growing frustrations led to a series of referendums, all of which were deemed illegal and non-binding by the Spanish Constitutional Courts and the Spanish government. Despite objections from the Spanish courts and central government, the referendums took place, albeit with very low turnout.

The latest referendum on October 1 was unique due to the extremes taken by the central government to stop it. Catalonia's refusal to back down from the central government sparked the biggest Spanish constitutional crisis in the country's history.

In Part II, we will discuss our expectations for how this showdown will transpire.

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November 6, 2017

*This report was prepared by Thomas Wash of Confluence Investment Management LLC and reflects the current opinion of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.*

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