The regional government in Catalonia plans a referendum asking “Do you want Catalonia to become a State?” and “In case of an affirmative response, do you want this State to be independent?” on 9 November 2014. This large, relatively affluent province makes sizeable fiscal transfers to Spain’s central government every year. Deep austerity-driven spending cuts have exacerbated Catalan bitterness about these transfers and compounded strong historical animosities. Polls within Catalonia now show majority support for at least “statehood”. Brian Lawson examines local Catalan and national political dynamics. Although he considers that greater Catalan autonomy, more fiscal independence or an orderly departure from Spain are all more likely than a hasty withdrawal, he focuses on the potential implications of a unilateral declaration of independence.

The strong performance of parties supporting self-determination in the European Parliament elections in May 2014, particularly the increase in support for pro-independence party Republican Left of Catalonia (Esquerra Republicana de Catalunya: ERC) from 9.2% in 2009 to a winning 23.7%, demonstrates that the risk of a rapid withdrawal is now significant.

Sudden separation would pose a substantial risk to Spanish bond investors after the rally to record-low yields in June 2014. Should Catalonia secede from Spain, risk managers must be prepared for public sector payment problems, currency uncertainty, possible trade restrictions caused by Catalonia being excluded from the European Union (at least temporarily), bank solvency fears, and industrial action and protests.

CURRENT CATALAN DEVOLUTION AND STALLED NEGOTIATIONS

Catalonia has a long-established national identity. It was among the first regions to regain autonomy in 1979 after the end of Franco’s dictatorship. A regional parliament was established in 1980, with a high degree of self-governance, including responsibility for healthcare and education, and the right to run its own police force. Since then, there has been on-going friction over the degree of self-government, particularly financial, as well as linguistic and cultural issues.
In 2012, fiscal negotiations broke down between Catalonia’s Convergence and Union (Convergència i Unió: CiU)-led government and Spain’s administration headed by the People’s Party (Partido Popular: PP) as the PP rejected CiU calls for a similar degree of fiscal control as the Basque Country. There, and in Navarra, a foral regime dating back to the 19th century allows almost all tax revenues to be retained locally. Ceding to Catalan demands would have damaged PP support substantially at both regional and national levels and provoked a hostile reaction from other autonomous regions at a time of severe national fiscal pressure and austerity.

CATALONIA’S FINANCIAL CONTRIBUTION TO THE CENTRE

Catalonia is one of Spain’s richest regions, with per capita income of EUR26,666 in 2013, compared with a national average of EUR22,279, and far higher than Andalucía (EUR16,666) and Extremadura (EUR 15,026), according to Instituto Nacional de Estadística data. National income and value-added taxes therefore act as mechanisms to generate net fiscal transfers. For 1986–2011, the regional government claimed it had made an average fiscal transfer to the rest of Spain of 8% of its GDP, as shown in the chart below.

Net monetary fiscal outflow from Catalonia (as % of GDP)

Source: Departament d’Economia i Coneixement: Generalitat de Catalunya, May 2013: Resultats de la balança fiscal de Catalunya amb el sector públic central.
National-level counterarguments claim that such calculations are biased and flawed, under-valuing centrally-provided government services, such as defence, and investments benefitting the region, such as the Madrid-to-Barcelona AVE high-speed train line. However, in a 2013 study based on 2010 fiscal flows Catalonia’s Department of Economics argued that even in results based on calculations using “fiscal beneficiaries” rather than “monetary flows”, persistent large outflows were generated. A recently released update based on 2011 data shows a similar story. As of June 2014, Spain’s national government has not produced regional fiscal balance data of its own.

<table>
<thead>
<tr>
<th>Fiscal balance: 2010</th>
<th>Calculated on monetary flows basis</th>
<th>Calculated estimating fiscal beneficiaries of expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payments from Catalonia (EUR mn)</td>
<td>61,872</td>
<td>60,577</td>
</tr>
<tr>
<td>Receipts in Catalonia (EUR mn)</td>
<td>45,329</td>
<td>49,319</td>
</tr>
<tr>
<td>Balance (EUR mn)</td>
<td>-16,543 (outflow)</td>
<td>-11,258 (outflow)</td>
</tr>
<tr>
<td>% GDP</td>
<td>8.5%</td>
<td>5.8%</td>
</tr>
</tbody>
</table>

Source: Departament d’Economia i Coneixement: Generalitat de Catalunya.

Catalonia is Spain’s most indebted region, with a debt stock of EUR57 billion at end-2013 (EUR25.4 billion at end-2009). Its debt per capita was EUR7,104, compared to a national average of EUR4,194. Catalonia’s 2013 fiscal deficit was 1.97% of GDP, one of the highest of Spain’s regions. Its debt is junk rated and the region relies on national government rescue funds. The national government blocked Catalonia’s attempts to raise stand-alone funding during 2014 because of its low rating and poor trading levels. Other regions, including Aragon, Extremadura, Galicia, Madrid, and Navarra, have successfully raised funds this year.

CATALONIA’S ACUTE BUDGETARY AND FUNDING PROBLEMS

Catalonia’s proposed referendum follows Scotland’s UK government-supported poll set for 18 September 2014 to decide independence or continued union, as explored by Adrian Rogstad in the previous issue of IHS Country Risk Quarterly. Catalonia’s road to potential independence faces far more complex risks and uncertainties than Scotland’s, as the Spanish government’s resistance to the Catalonia poll alone creates a series of additional hurdles, and a vast range of alternative outcomes.

CATALAN POLITICAL POWER AND VOTING LOGISTICS

The CiU has already held one election over the issue, calling early regional elections to seek popular support for self-determination following the 2012 fiscal stand-off with the national government. In the resulting November 2012 poll, the CiU was re-elected as the largest party but lost vote share, forcing it to rely on informal support from the ERC. Based on the 25 May 2014 European election results, the prospect of the ERC becoming the region’s largest party is substantial. The ERC has suggested it aims to complete secession by 2016. Unilateral secession is therefore a risk and threatens the region’s membership of the European Union and the Eurozone.
Catalan elections in 2015 would represent a constitutionally-sound channel for the region’s population to express its desire to leave Spain.
A declaration of unilateral independence would affect Spain’s sovereign credit rating, Catalunya’s access to external funds, and the less wealthy regions of Spain

RISKS OF A RAPID CATALAN WITHDRAWAL FROM SPAIN

We anticipate that the Catalan government will seek to avoid a hostile exit from Spain, with greater federal autonomy and fiscal independence or a slower and more orderly negotiated departure among more likely potential scenarios. However, the risk of the ERC winning new regional elections and declaring unilateral independence is now significant. The following are potential implications risk management teams may wish to consider for their contingency planning:

Payment problems

• Spain’s sovereign credit rating
  Catalonia was the largest contributing province to Spain’s 2013 GDP, narrowly ahead of Madrid, at almost 19% of GDP (EUR192.5 billion). Spain’s debt-to-GDP ratio would jump to 116.4% from 96.5% in February 2014 if Catalonia broke away and refused to contribute to Spain’s debt service, probably as a leverage tool with the central government. A unilateral Catalan exit from Spain would also carry significant contagion risk, particularly for the Basque Country. The country’s fragmentation would surely prompt a rapid reversal of recent ratings upgrades and could lead to a funding crisis, forcing the country towards European Union/Troika support again.

• Within Catalonia
  A stand-alone Catalonia could encounter significant funding problems. According to influential economist Ramón Tamames, after including additional government borrowings to smooth post-independence economic adjustment and accepting its share of Spain’s liabilities, Catalonia could face total government indebtedness of EUR270 billion (135% of its GDP). With the region already junk rated and blocked from market funding, it could face significant threats to its stand-alone ability to access external funding, probably also without access to European Union rescue mechanisms. In turn, these weaknesses would threaten an increase in payment delays for state contractors, notably in the education, healthcare, and welfare sectors. In the worst case, temporary limitations on currency flows could be implemented.

• Less wealthy regions of Spain
  Fiscal transfers represent a significant proportion of regional government income in less wealthy Spanish regions. In Extremadura, for example, they contributed just over EUR1 billion of the total fiscal receipts of EUR2.8 billion in 2013. In the event of independence, the cessation of fiscal flows from Catalonia could be expected to increase funding problems and the need for additional central government support for regions including Andalucía, Castilla-La Mancha, and Extremadura. If a deal were reached for Catalonia to remain within Spain, reduced fiscal transfers would be likely to form part of this agreement, also affecting recipient regions but on a smaller scale. Businesses in these areas could face increased payment delays on official contracts, despite current central government efforts to improve Spain’s weak record in this area, and increased local taxation to fill the gap.

Currency uncertainty

Catalonia faces a high risk of exclusion from the European Union and Eurozone, at least initially. Its government is likely to seek to peg to the Euro, if forced to introduce its own currency, reducing direct currency risks. However, there are serious risks to its external position. In 2013, Catalonia had a trade deficit with the world, ex-Spain, of EUR8.3 billion (just over half of Spain’s overall trade deficit). It is unclear if the region would obtain any official currency reserves on departure from Spain to help bridge this deficit. If not, it would rely on capital inflows (foreign direct investment and portfolio inflows) to achieve external balance, which might not be forthcoming, especially under an ERC-led administration. Without such inflows, Catalonia would face a potentially unsustainable external position, raising the risk of possible capital controls in the worst case.
Banking sector pressures

Two of Spain’s top-five banks, CaixaBank and Banco Sabadell, are based in Catalonia. Catalan-based banks would lose access to new finance from the European Central Bank if excluded from the Eurozone, and could face refinancing risks and increased funding costs. In turn, they would face pressure to limit business lending, reflecting reduced access to funding, potential withdrawal of deposits by Spanish investors, and possible curtailment of credit lines by international banks. Relocation and separation of non-Catalan operations into separate subsidiaries are therefore likely in the event of independence. For Banco Sabadell and CaixaBank, Catalan branches account for only approximately 32% and 27% of their total networks, respectively.

Possible barriers to Catalan exports

Catalonia generated EUR58.4 billion of Spain’s exports in 2013, 25% of the total. Seventy two percent of Catalan exports went to other European countries, including in the key sectors of chemicals (EUR15.5 billion), machinery (EUR10.2 billion), and automotive products (EUR 8.6 billion). Exclusion from the European Union would expose Catalonia’s exports to tariffs, with tariff barriers threatening both supply and demand chains with the rest of Spain and European Union export destinations. While many businesses would be at risk, operations used by multinational companies, such as the SEAT/vw plant at Martorell, would be especially at risk of relocation. If Catalonia had to apply for European Union membership from scratch, in the face of Spanish opposition, it would be likely to face trade problems with the European Union for an extended period.

Consumer boycotts of Catalan goods

In previous periods of regional sensitivity, Spanish consumers have boycotted obviously Catalan products. After these boycotts, the production of some goods left Catalonia. Catalan banks could also suffer. Well-established national operators like Gas Natural and motorway/infrastructure group Abertis would face substantially lower risks.

Civil disorder

So far, nationalist demonstrations have been relatively infrequent and almost wholly peaceful. However, fringe groups have infiltrated various peaceful demonstrations in Barcelona, blocking roads, and causing a low level of property damage to banks, shops, and official buildings. In the event of a pro-independence vote being rejected by Spain, there is clear potential for an increased number of strikes in protest, large-scale demonstrations, and a refusal to pay taxes. These protests could well become more violent, especially against symbols of national government and Spanish businesses. A further likely trigger of greatly-heightened violence would be the suspension of the region’s autonomy for exceeding its powers. So far, suspension has been suggested by anti-regionalist party Union, Progress and Democracy (Unión Progreso y Democracia: UPyD) without gaining support from either the government or the principal socialist opposition party.

National riot police could be used to control major disturbances in Catalonia. Indeed, 200 were deployed temporarily to Barcelona in May 2014, without Catalan invitation, to contain the Centro Social Autogestionado Can Vies protests against the eviction of squatters and demolition of the building. Local police units asked riot police to remain on the sidelines, however, and their brief involvement was limited to protecting official buildings. National units would be likely to meet greater violence from radical pro-independence supporters in future, raising the scope for severe injuries or fatalities, which could further escalate violence.

Nationalisation and taxation risks

Several opinion polls have suggested that the ERC could emerge as the region’s largest party in a future election. This would probably increase the risk of government amendments to existing commercial contracts. It would likely heighten the risk that key sectors such as telecommunications could be nationalised. It could also prompt stricter policies towards the financial sector, and increased taxation for those with above-average incomes or wealth.