

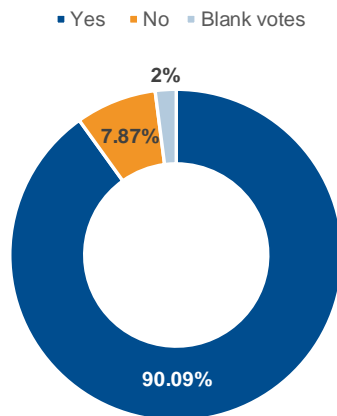
Catalonia to Remain in Spain Despite Referendum, But Tensions Escalate



On Sunday, the regional Catalan government held a non-binding referendum on independence from Spain, gaining a 'mandate' for secession. Regardless of any unilateral declaration of independence, Scope considers it unlikely that the movement succeeds in leading to the independence of Catalonia in the medium-term. An activation of Article 155 by the central government to assume control over Catalonia is possible, if secession preparations escalate. In Scope's view, the most likely outcome over the long term remains further devolution of power, with greater fiscal and/or political autonomy to Catalonia.

In the referendum on 1 October, held despite a ruling of unconstitutionality, 90% of votes (an estimated 2 million votes) were reported to have been cast in favour of independence. However, turnout was low at 42.6%. On the basis of the results, the Catalan government has asserted it has a mandate for independence.

Figure 1: Catalan independence referendum results, October 2017 (turnout: 42.6%)



Source: Government of Catalonia

Regardless of any unilateral declaration of independence, Scope considers it unlikely that secessionists succeed in leading to the independence of Catalonia in the near- to medium-term, owing to multiple legal, institutional, economic and financial reasons. Scope's baseline remains that Catalonia will remain part of Spain. Obstacles remain to Catalan independence stemming from the Constitution but also from the fact that public opinion in the rest of Spain remains against Catalan secession (blocking chances for constitutional reform creating a legal road to independence). In addition, Catalonia lacks the means and international support to pursue independence unilaterally.

If Catalonia escalates secession actions significantly, it is possible that the central government would invoke Article 155 to assume temporary direct control over Catalonia. In Scope's view, while progress towards any form of settlement may be restricted in the near term, the most likely outcome over the long term remains a negotiated further devolution, including greater fiscal and/or political autonomy being granted to Catalonia.

Scope does not expect the Catalonia crisis to result in any change to Spain's A-/Stable long-term sovereign rating and outlook. However, ongoing tensions can still be credit negative if they escalate significantly or last long enough, curbing business and consumer confidence. More adverse scenarios of a 'Catalexit' from Spain, while not expected, would hold significantly more negative credit implications.

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Overwhelming majority on low turnout

Non-binding referendum

On 1 October, the regional Catalan government held a non-binding referendum on independence from Spain. The vote was judged to be illegal by Spain's Constitutional Court on 7 September 2017 – the Spanish Constitution states, in essence, that only all of Spain's people can vote on acts that alter the constitution.

In Sunday's referendum, 90% of votes (an estimated 2 million votes) were reported to have been cast in favour of independence, according to the Catalan government¹. However, turnout was low at 42.6% (2.3 million total votes cast from 5.3 million registered voters). Regional authorities blamed the police crackdown for the low turnout, though the central government noted that even the reported turnout may be somewhat exaggerated owing to a lack of checks against double voting. A similar non-binding, unconstitutional Catalan self-determination referendum was held in 2014 with 81% of votes cast favouring independence (on turnout of about 37%), which was not recognised by the Spanish government or the European Union (EU).

A questionable mandate for independence

In Scope's opinion, given the illegal nature of the vote, low turnout and ambiguous accuracy of the 2 million votes cast for independence (according to broader opinion polls, the independence movement does not hold an overwhelming majority in Catalonia), the claim of the Catalan government to have a strong mandate for independence on the basis of Sunday's referendum is dubious, even though the movement does clearly enjoy significant local support.

What are Catalonia's options?

Potential independence declaration...

According to the referendum law passed by the Catalan Parliament in September – and declared illegal by Spain's Constitutional Court – after a final referendum result is discussed, the Catalan parliament has 48 hours to declare independence if the result is positive for independence. Catalan President Carles Puigdemont is scheduled to deliver the result to parliament on Monday, 9 October. In principle, the Catalan assembly can move ahead with the independence declaration thereafter, though the timing is unclear. Spain's Constitutional Court on Thursday ordered the suspension of Monday's parliamentary session – with the intent to stem such an independence declaration; however, Catalonia has stated it will proceed with the session in some form.

Scope's baseline is that Catalonia remains part of Spain

Regardless of any unilateral declaration of independence, Scope's baseline is that Catalonia remains part of Spain. Obstacles to Catalan independence include the issue that any form of unilateral independence is prohibited by the constitution, inhibiting a lawful separation. In addition, public opinion in the rest of Spain remains against Catalan secession (unlike for instance in Norway's successful separation from a cooperative Sweden in 1905), blocking chances for constitutional reform facilitating a legal, official independence referendum in Catalonia (like the one held in Scotland in 2014). Next, the Catalan secessionist movement does not hold an overwhelming majority, despite the one-sided referendum result, with the broader Catalan electorate divided on the issue. Also, Catalonia lacks the means and international support to pursue independence unilaterally. And, the economic and financial costs restrict movements towards a disorderly secession owing to resulting political and social instability.

¹ http://www.catalangovernment.eu/pres_gov/government/en/infographics/303482/catalan-referendum-results.html

In a 20 September article on Bloomberg View², Leonid Bershidsky argued that learning from past successful secessionist movements, a successful secession can only occur if one of several preconditions is met: either i) a binding independence referendum is held with the cooperation and sponsorship of the central government, and is thus legal and consensual, ii) the separatists have *escalation dominance* owing to the relative weakness of the sovereign, allowing independence at the threat of conflict³, or iii) the separatists are willing to engage the sovereign's military in a violent, drawn-out insurrection.

Scope considers the first route to be blocked by the central government, particularly so long as the Partido Popular (PP) remains in power. Catalonia appears to have neither the means nor will at this stage to pursue either the second or third possible avenue, without international support. The Catalan movement has been peaceful over past decades, with the exception of the defunct Terra Lliure group. In addition, Scope is mindful of the fact that the Basque Country's ETA failed in its own objectives of bringing about its region's independence from Spain, after near a half century of resistance.

To date, the EU, the United Kingdom and the United States amongst others have rejected Catalan appeals to intermeditate, stating the issue to be a domestic one between the Spanish and Catalan governments, adding that the Spanish Constitution must be adhered to. The EU also has stated that an independent Catalonia would be outside the EU and the Single Market and that the Catalan financial system would be cut off from European Central Bank funding.

What's next?

The main threat available to Prime Minister Mariano Rajoy is Article 155 of the Spanish Constitution, allowing the central government to assume direct control of Catalonia, suspending the Catalan government, per emergency rights under the Constitution when disobedience 'gravely threatens the general interest of Spain'.

Such an act by Madrid carries significant risks, however, and may exacerbate aspects of the crisis. Importantly, Rajoy's weak minority government may restrict somewhat his room for manoeuvre on this, with his party dependent on support from small regional parties, including the Basque Nationalist Party (PNV), after an inconclusive 2016 election. PNV has withdrawn support for the 2018 national budget in protest of Mr Rajoy's response to Catalonia. While elements of his party will push for Article 155 to be activated, Mr Rajoy will be mindful of the lack of cross-parliamentary support (and the risk of another early general election if his government fails).

Moving ahead, much depends on just how far the Catalan government is willing to go unilaterally in seeking secession, beyond the anticipated verbal declaration. The Catalan government – made up of a diverse Together for Yes (JxSí) political alliance and the radical Popular Unity Candidacy (CUP) – are themselves divided on the extent of the split desired, with some factions wanting an unconditional exit from Spain and the EU and others wishing for a soft exit from Spain, but not from the EU. The regional government's moderates are pushing for dialogue with Spain, concerned that unilateral moves on independence could endanger the region's economy. Given the division of opinion within the Catalan government and the vulnerabilities of Prime Minister Rajoy's minority government, the extent of the Catalan push for independence and reactionary punishment from Madrid is likely to see continued push-and-pull, with the Catalan government perhaps forcing the issue in the near term, owing to a need to capitalise on present fervour after the referendum and hoping pushback raises international attention.

Appeals for international intervention

Spain could assume direct control of Catalonia

Much depends on how far the Catalan government pushes

² <https://www.bloomberg.com/view/articles/2017-09-20/catalan-separatists-are-on-a-path-to-failure>

³ This was arguably the case during the collapse of the Soviet Union.

Greater central government intervention in Catalonia already established

Any delays or uncertainty on independence, moreover, increases the potential for internal instability in the regional government – raising the spectre of an early regional election.

Any negotiations will be made arduous owing to the considerable distance and lack of trust between the two sides. If Catalonia escalates secession actions significantly, however, Scope considers it possible, if not probable, that Article 155⁴ is activated in this scenario and central government rule temporarily imposed, with an intent to call an early regional election for a later date. Whether this might weaken Rajoy's government, if supporting parties like PNV voice dissent, depends on the conditions under which emergency powers are invoked and the degree of support from opposition groups. If Spain assumes control over Catalonia, this would obstruct formal preparations for independence, but it would also risk stoking further dissent and demonstrations – with the national police and Civil Guard required therein to enforce the order. Whether or not Article 155 is used, the greater presence of the central government in Catalan affairs and finances is already established, and will be a source of continued tensions.

Scope expects greater devolution long term

In Scope's view, while progress towards any kind of settlement may be restricted in the near term by prevailing hostilities, the most likely outcome over the long term remains negotiations for further devolution, which includes a greater degree of fiscal and/or political autonomy given to Catalonia, if not also other autonomous regions. This could include in possible areas like language and identity, justice and the term 'nation' to designate Catalonia within Spain – areas overturned in a landmark 2010 Constitutional Court ruling, which partially precipitated the current independence drive.

Such a broader discussion on a new constitutional settlement requires concessions from both sides, something perhaps not currently possible, but may become more realisable under different circumstances and new governance at the central and/or regional levels in the future. For example, a central government that includes the Socialist Party and/or the leftist Podemos might be more amenable to allowing a non-binding referendum as a matter of free speech and/or entertaining greater political and/or fiscal devolution for Catalonia. Moreover, Spain's ongoing economic recovery could help ease the independence groundswell in Catalonia somewhat. However, future negotiations will be restricted by the already significant autonomy that Catalonia enjoys, and the need to stem moral hazard in other break-away regions wanting similar deals, notably in the Basque Country and Galicia.

Presently, no change in Spain's ratings being considered

Implications of the Catalonia crisis

Scope expects Catalonia to remain within Spain, even if turmoil escalates in the near term, and does not expect the Catalonia issue to result in a change to Spain's A-/Stable long-term sovereign rating and outlook. Spain has seen 15 consecutive quarters of economic growth, with the annual growth rate standing at 3.1% as of Q2 2017 – amongst the highest in the euro area, and the government's budget deficit (of 4.5% of GDP in 2016) is on a gradual correction course. The government debt ratio, while high at 100% of GDP in Q1 2017, has peaked, and is expected to modestly decline moving ahead (notwithstanding any regional fiscal slippage).⁵

A 'Catalexit' scenario would be much more credit negative

More adverse scenarios of a 'Catalexit' from Spain would hold significantly more credit negative implications. Catalonia represents 16% of Spain's population, 20% of Spain's

⁴ If an Autonomous Community does not fulfil the obligations imposed upon it by the Constitution or other laws, or acts in a way that gravely threatens the general interest of Spain, the Government, after lodging a complaint with the President of the Autonomous Community and failing to receive satisfaction therefore, may, following approval granted by an absolute majority of the Senate, take the measures necessary in order to compel the latter forcibly to meet said obligations, or in order to protect the above-mentioned general interests. With a view to implementing the measures provided in the foregoing clause, the Government may issue instructions to all the authorities of the Autonomous Communities.

⁵ Scope noted the Spanish sovereign's credit strengths and limitations in 'Scope confirms and publishes Spain's credit rating of A- and changes the Outlook to Stable' published on 30 June 2017.

economy and 21% of taxes paid in 2016. Spanish and Catalan financing rates would spike in the scenario of a disorderly exit⁶; in this scenario, a severe recession would result in both the region and country that potentially spills over to neighbouring nations. Even more than the costs of a messy Catalan exit to Spain are the costs to Catalonia itself. A Barcelona-based drug-maker announced its relocation to Madrid this week and contingency planning has started in other companies, including Catalan banks (with Banco Sabadell announcing its headquarters' relocation on Thursday, and CaixaBank considering the same). However, Scope considers that, in the long run, any scenario in which Catalonia exits Spain is more likely to be orderly – involving a legal transition with the support of a cooperative Spanish central government along with a deal on the sharing of liabilities/assets – than disorderly.

Economic implications increase if tensions remain or escalate

However, even if Catalonia remains in Spain over the long run, ongoing tensions can still be credit negative if they escalate significantly or last for long enough. Ongoing uncertainties could negatively impact business confidence in the region and in the country, and reduce investment. Volatility in financial markets has risen, with an increase in Spain's 10-year yield spread to 128 bps (to German Bunds) as of Friday, from 114 bps before the referendum. Volatile moves in Spain's IBEX 35 equity index have been seen, while Catalan bank shares have fallen.

Figure 2: Spain 10-year government bond spread, bps, 2017



Source: Bloomberg, as of 6 October 2017

Spain guarantees Catalan government debt

In addition, Scope notes that Spain guarantees most of Catalonia's government debt stemming contagion in debt capital markets. The Spanish government recently reiterated its guarantees to creditors of the Catalan government and that these guarantees extend beyond the referendum vote. Catalan government debt amounts to EUR 75bn in 2016 with 68% of the debt held by the Spanish government. Since July 2012, Catalonia has been predominantly funded by the Fondo de Liquidez Autonómica (FLA), a credit line from the central government to regional governments. Since the FLA was launched, Catalonia has received approximately EUR 63bn from the fund and is due to receive another EUR 3.6bn in 2017. It is Scope's view that the current arrangements should counteract contagion from the ongoing political tensions, provided Spanish debt remains on a sustainable path.

⁶ The Catalan Parliament's 'transitional' law of 8 September proclaims sovereignty, without guaranteeing it will fulfil obligations it has to the rest of the nation, like contributing toward paying its portion of the national debt.



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