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# Sovereign implications of Catalonian independence

*Update: This replaces the version published on 22 October, correcting the percentage of total population column in Figure 2.*

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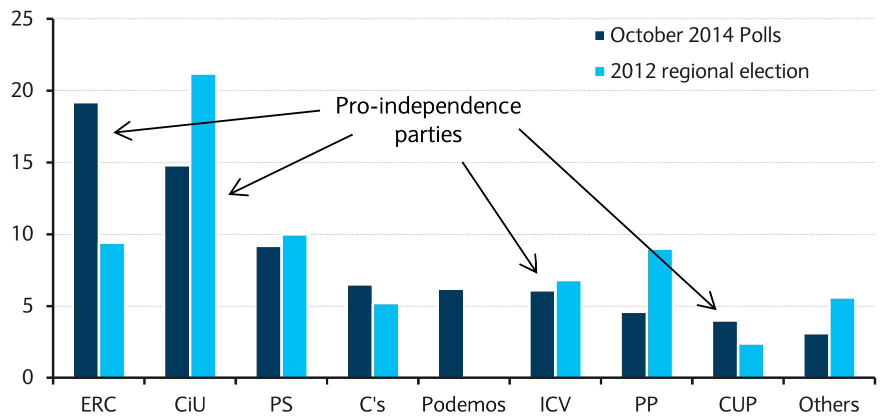
- Markets appear calm about recent political developments in Catalonia, viewing the likelihood of the region gaining independence from Spain as remote. We believe markets are overly complacent about this risk, as the likelihood of independence is non-negligible (Figure 1), and the economic costs of such a scenario would be significant for Catalonia, Spain, and Europe. With the recent increase in risk aversion, downside risks to European growth and adverse debt dynamics, we think that independence risks have the potential to trigger further volatility.
- Political tension escalated as the Catalonian government called for an independence referendum on 9 November 2014, which was deemed illegal by the Spanish constitutional court. It is not yet clear what form of unofficial referendum will take place in November. More importantly, regional elections are due to take place no later than May 2015 and are likely to happen earlier. The radical-left, pro-independence party *Esquerra Republicana de Catalunya* (ERC) leads in the polls. Independence could be fast-tracked if ERC wins a large majority, a scenario that cannot be fully dismissed.
- Spain would likely struggle to absorb such a shock given the deflation and weak growth dynamics, the size of the Catalonian economy (18.9% of Spain's GDP), Spain's large negative net international investment position (c.95% of GDP), high public debt (over 100% of GDP next year) and a primary balance that is still c.4.0pp of GDP away from the debt-stabilising level. The selloff in Spanish assets and a possible return of redenomination risk would likely require some form of ECB intervention to limit volatility and contagion.
- Markets would need to monitor whether pro-independence support moderates should the central and regional governments soften their positions and agree on a new regional financing mechanism and some institutional changes. There are no official proposals in this direction yet.

FIGURE 1

**Pro-independence ERC leading the regional polls in Catalonia**




Source: Metroscopia

## An escalating conflict

Spanish and international investors do not appear overly concerned about Catalonian independence. Given that Catalonia accounts for nearly 19% of Spain's EUR1.08trn GDP, about one-third of the EUR1.01trn of Spanish public debt held abroad and has a negative net international investment position of EUR1.02trn, it is evident that Catalonia's independence would be a major market event for Spain and Europe. As recent markets jitters show, investors seem increasingly concerned about global growth prospects, especially in Europe. Therefore, we believe the risk of Catalonia independence, even if it is not a baseline scenario, should be closely watched.

*Tensions increased between the central government and the regional government following the call for an independence referendum*

There has been an escalation in the rhetoric between the Spanish central government and the regional Catalonian government on the issue of independence in recent months. It has been fed by the regional government's support of a pro-independence referendum scheduled for 9 November 2014. The referendum was suspended by Spain's Constitutional Court after it accepted a challenge submitted by the central government against the referendum on 29 September 2014. The court is expected to reach a verdict within five months, but in the interim, the referendum cannot be held legally.

Whether or not the regional authorities decide to go ahead with some kind of unofficial referendum – which may not have immediate implications other than higher market volatility – we think Catalonia independence will remain a concern for the markets until an acceptable solution is found. Regional elections are due no later than end-May 2015. The regional government and other pro-independence parties have signalled earlier regional elections. The period ahead of the elections is likely to be volatile as the outcome of the election is very uncertain. Possible negotiations between the central government and the more moderate regional parties may condition the outcome.

FIGURE 2

**Catalonia – large and wealthy relative to peers**

| | Population | (% of total) | GDP (EUR mn) | (% of total) | GDP per cap. (EUR) | GDP per cap. index (Spain = 1) |
|---|---|---|---|---|---|---|
| Total Spain | 46,818,216 | 100.0 | 1023.0 | 100.0 | 22,279 | 1.00 |
| Andalucía | 8,377,809 | 17.9 | 138.3 | 13.5 | 16,666 | 0.75 |
| Aragón | 1,343,790 | 2.9 | 32.3 | 3.2 | 24,732 | 1.11 |
| Asturias | 1,074,304 | 2.3 | 21.4 | 2.1 | 20,591 | 0.92 |
| Baleares | 1,100,715 | 2.4 | 26.1 | 2.5 | 23,446 | 1.05 |
| Canarias | 2,085,928 | 4.5 | 40.3 | 3.9 | 18,873 | 0.85 |
| Cantabria | 592,387 | 1.3 | 12.4 | 1.2 | 21,550 | 0.97 |
| Castilla y León | 2,537,654 | 5.4 | 53.5 | 5.2 | 21,879 | 0.98 |
| Castilla - La Mancha | 2,105,936 | 4.5 | 36.0 | 3.5 | 17,780 | 0.80 |
| Catalonia | 7,514,992 | 16.1 | 192.5 | 18.8 | 26,666 | 1.20 |
| Valencia | 5,009,647 | 10.7 | 97.3 | 9.5 | 19,502 | 0.88 |
| Extremadura | 1,104,343 | 2.4 | 16.2 | 1.6 | 15,026 | 0.67 |
| Galicia | 2,771,916 | 5.9 | 55.2 | 5.4 | 20,399 | 0.92 |
| Madrid | 6,425,573 | 13.7 | 183.3 | 17.9 | 28,915 | 1.30 |
| Murcia | 1,461,928 | 3.1 | 26.3 | 2.6 | 17,901 | 0.80 |
| Navarra | 640,023 | 1.4 | 17.6 | 1.7 | 28,358 | 1.27 |
| País Vasco | 2,184,696 | 4.7 | 62.8 | 6.1 | 29,959 | 1.34 |
| Rioja | 320,951 | 0.7 | 7.8 | 0.8 | 25,277 | 1.13 |

Source: INE, Barclays Research

To be better understand the market implications of potential independence, in this note we first discuss Spain's economic and fiscal links with its regions, especially with Catalonia. We then review the regions' fiscal performance and their rapidly increasing stock of public debt in a context of lowflation and weak growth. We describe how the lion's share of Catalonian public debt is with the Spanish central government – like most regions, Catalonia turned to the central government when it lost market access, and some remain constrained by their sub-investment grade credit ratings. We also discuss the financing arrangements and the regional fiscal balances, which are likely to be key issues in the debate between the central government and the regions ahead of the 2015 elections. Those readers already familiar with these issues may wish to skip directly to the last two sections, where we discuss the next political steps for Catalonia; what a possible path to independence would look like; and its potential economic costs and some likely market implications.

## The economic and fiscal links

*Catalonia represents 18.8% of Spain's GDP and has above-average per capita income*

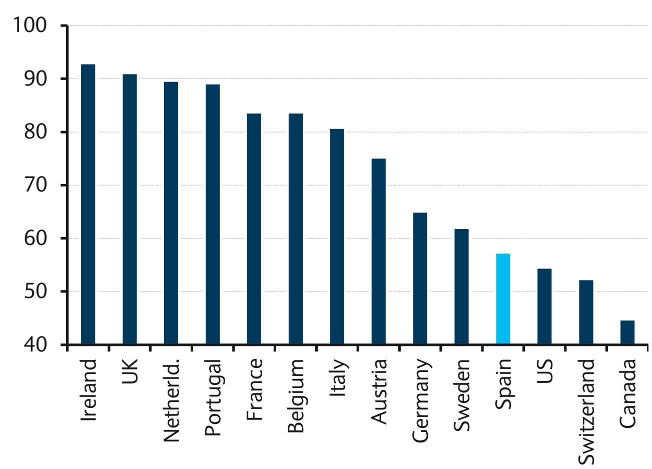
The Kingdom of Spain is divided into 17 autonomous communities and two autonomous cities. The regions are further divided into 50 provinces and 8,112 municipalities. With c.17.9% (8.4mn) of Spain's total population of 46.8mn, Andalusia is the largest autonomous community, followed by Catalonia (16.0%), Madrid (13.7%) and Valencia (10.7%). Catalonia makes the largest contribution to Spain's GDP, at 18.8%, followed by Madrid at 17.9% and Andalucia at 13.5%. In per capita terms, the highest income is in the Basque Country, EUR29,959, followed by Madrid, EUR28,915, Navarre, EUR28,358 and Catalonia EUR26,666; in contrast, Andalucia's per capital income is just 16,666 (Figure 2).

*Spain is already one of the most de-centralised countries in Europe*

Spain is already one of the most decentralised countries in the euro area, if not the most. The 1978 Constitution grants the regions clear competencies in many areas, including education, health, public works in their territory, and the environment. As a result of the fiscal devolution process, the central government currently controls less than 30% of public expenditures, excluding social security and public debt service. The process of fiscal devolution has been very intense over the past two decades. For instance, in the 1980s, sub-national governments were responsible for c.15% of total public expenditures and the regions accounted for just 6% of total public sector employees. In 2013, the regions accounted for well over 50% of both public expenditures and public sector employment (Figures 3-4).

FIGURE 3

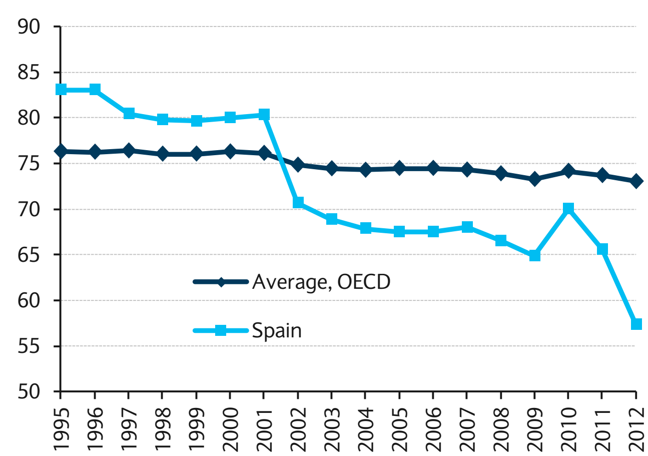
**2012 central government public expenditure as % of total public expenditure**




Source: OECD, Barclays Research

FIGURE 4

**Public expenditure by the central government (% total): fiscal devolution**




Source: OECD, Barclays Research

*Catalonia has very close trade links to other parts of Spain and the rest of Europe*

Catalonia has a service-based economy, with about 71% of gross value added contributed by the service sector. The largest contributor to this sector is public administration (education and health are 21.3%), followed by trade and motor vehicle repair (19.3%), professional, scientific and technical activities (12.2%), and tourism and restaurants (10.5%). Industry accounts for 20.6%, of which chemicals, pharmaceutical and petroleum products represent 18.2%. Catalonia has a comparatively more open economy than Spain. About 25% of Spain's goods exports are from Catalonia. Like the rest of Spain, Catalonia has close trade links with Europe: 63% of its exports go to the euro area and c.10% to the rest of the EU. Despite its comparatively stronger economic fundamentals, Catalonia's fiscal performance has lagged behind many of Spain's other regions, and this led most rating agencies to downgrade Catalonia (and several other regions) to sub-investment grade (Figure 5).

FIGURE 5

**Market access remains constrained for many regions under current ratings**

| Region | Ticker | Moody's | S&P | Fitch |
|---|---|---|---|---|
| Andalucia | ANDAL | Ba1 (POS / 27-Feb-14) | BBB- (STABLE / 30-May-14) | BBB- (STABLE / 13-Dec-13) |
| Aragon | ARAGON | - | BBB (STABLE / 30-May-14) | - |
| Canarias | CANARY | - | BBB (STABLE / 30-May-14) | BBB- (STABLE / 13-Dec-13) |
| Cantabria | CMDCA | - | - | BBB (STABLE / 13-Dec-13) |
| Castilla y Leon | CASTIL | Baa2 (POS / 27-Feb-14) | - | - |
| Castilla-La Mancha | MANCHA | Ba2 (POS / 27-Feb-14) | - | BBB- (STABLE / 13-Dec-13) |
| Catalonia | GENCAT | Ba2 (POS / 27-Feb-14) | BB (STABLE / 30-May-14) | BBB- (STABLE / 13-Dec-13) |
| Madrid | MADRID | Baa2 (POS / 27-Feb-14) | BBB (STABLE / 30-May-14) | BBB (STABLE / 25-Jul-14) |
| Navarre | NAVARR | - | A- (STABLE / 13-Jun-14) | - |
| Valencia | VALMUN | Ba2 (POS / 27-Feb-14) | BB- (STABLE / 30-May-14) | BBB- (STABLE / 13-Dec-13) |
| Extremadura | JUNTEX | Baa3 (POS / 27-Feb-14) | BBB (STABLE / 30-May-14) | - |
| Galicia | JUNGAL | Baa2 (POS / 27-Feb-14) | BBB (STABLE / 30-May-14) | - |
| Baleares | BALEAR | - | BBB- (STABLE / 30-May-14) | - |
| Rioja | PRIO | - | - | - |
| Basque Country | BASQUE | Baa1 (POS / 27-Feb-14) | A- (STABLE / 13-Jun-14) | BBB+ (STABLE / 14-Mar-14) |
| Asturias | PRIAST | - | - | BBB (STABLE / 21-Feb-14) |
| Murcia | MURCIA | Ba2 (POS / 27-Feb-14) | - | BBB- (STABLE / 13-Dec-13) |
| Spain | | Baa2 (POS / 21-Feb-14) | BBB (STABLE / 23-May-14) | BBB+ (STABLE / 25-Apr-14) |

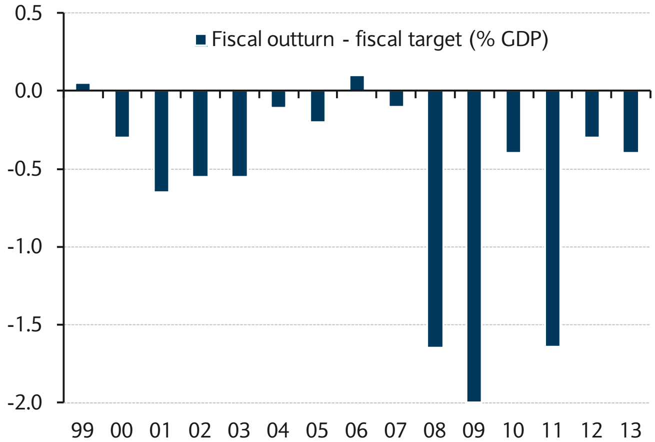
Source: Bloomberg, Moody's, S&P, Fitch, Barclays Research

## Dismal fiscal performance

The fiscal performance of Spain and its regions worsened sharply after 2008, as real estate-related revenues dwindled rapidly and unemployment skyrocketed. The rapid accumulation of deficits pushed overall public debt from 35.5% of GDP in 2007 to 96.4% of GDP by Q2 2014, and it is projected to rise to over 100% of GDP next year. The sharp increase in public debt was also the result of the repayment of arrears by the central and regional governments, bank recapitalisation costs and a contraction in nominal GDP. Indeed, in a deflationary environment with a moderate growth outlook, the debt dynamics for Spain will continue to be a significant risk (see *Deleveraging with low Inflation*, 24 March 2014).

FIGURE 6

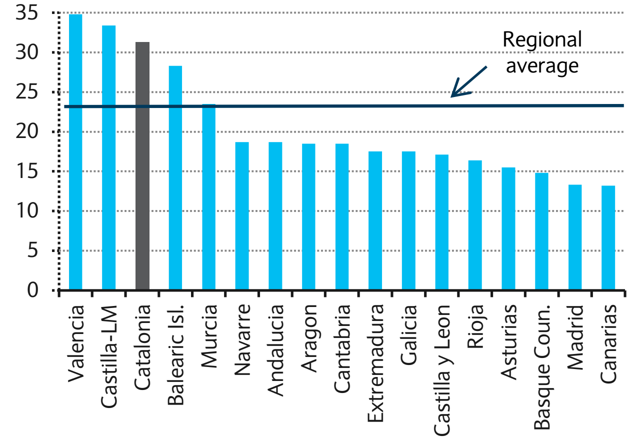
**Weak fiscal performance by the regions (% of GDP)**




Source: Bank of Spain, Barclays Research.

FIGURE 7

**Catalonia's public debt ratio is higher than most peers (Public debt/GDP, %)**




Source: Bank of Spain, Barclays Research.

*Even prior to the crisis the fiscal performance was already weak*

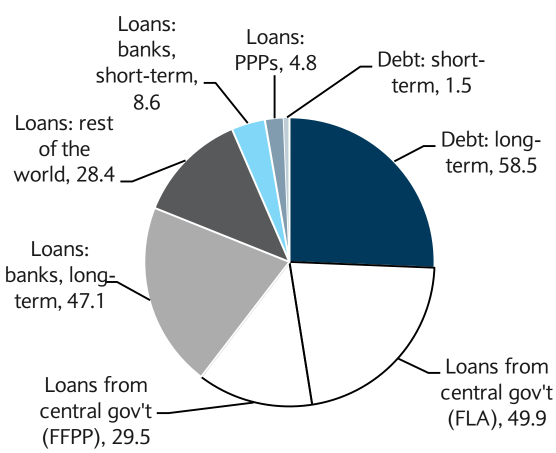
Catalonia, like other Mediterranean coastal regions, also saw its deficit and debt dynamics deteriorate during the real estate bust. But even prior to the crisis, the fiscal performance of most of the regions was already weak. The Spanish regions missed their fiscal deficit targets every year between 2000 and 2008, by an average of 0.3pp of GDP. The largest miss, however, was recorded in 2009 by 2% of GDP (Figure 6). As a result of their weak fiscal performance, total regional debt more than tripled, reaching 21.7% of GDP by Q2 14. Catalonia's debt rose even faster, reaching 31.3% of GDP (Figure 7).

*A large part of Catalonia's public debt, EUR61.8bn, is with the central government*

The stock of Catalonia's public debt, EUR61.8bn, is split between debt of EUR13bn and loans of EUR48.9bn, of which EUR27.8bn are loans from the central government. The central government became Catalonia's largest creditor when capital markets were closed to several regions, including Catalonia (Catalonia is still rated sub-investment grade by Moody's and S&P, and is rated BBB- by Fitch) during the eurozone crisis. Catalonia is the largest user (EUR21.3bn) of the Fondo de Liquidez Autonomico (FLA), the credit facility set up by the central government to provide funding to the regions. The central government has also provided funds to the regions to clear arrears with their public services providers,

FIGURE 8

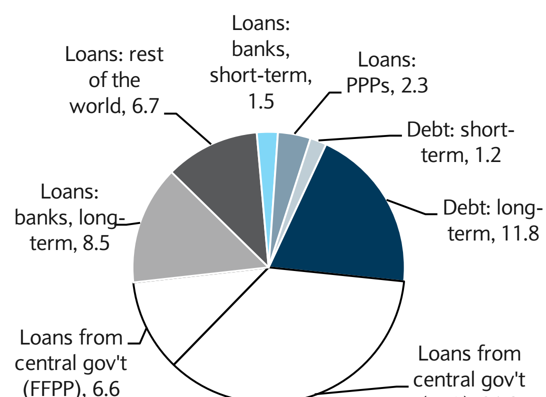
**Regional public debt by type of instrument (EUR bn)**




Source: Bank of Spain, Barclays Research

FIGURE 9

**Catalonia's public debt by type of instrument (EUR bn): the central government is the main creditor**




Source: Bank of Spain, Barclays Research the *Fondo para la Financiación de los Pagos a Proveedores* (FFPP), from which Catalonia has drawn EUR6.6bn (Figures 8-9). Regions are not allowed to issue public debt unless they can fund themselves at a spread no larger than 50bp over SPGBs.

## The regional financing system: amendments needed

*While expenditure responsibilities are well defined in the constitution, financing is not. This issue, along with inter-regional solidarity, has been a source of tensions*

In contrast to the well-defined competencies and expenditure responsibilities, the Spanish constitution provides only "general principles" on the financing of the regions. This has been a key political issue and has often created friction between the central government and the regional governments, especially with regard to inter-regional transfers. Furthermore, the central government has often needed the support of regional political parties in parliament to form a majority government (as was the case with the previous government, which needed support from the Catalonian regional government). As a result, the process of fiscal devolution has been driven largely by political considerations. Specifically, Catalonian leaders have demanded a more equitable distribution of both revenues and expenditures, which would leave greater fiscal resources within the region.

FIGURE 10

**Regional tax revenues under the "common" regime (ex-Basque Country and Navarre)**

| | Tax | Sharing (%) | Discretion |
|---|---|---|---|
| Ceded taxes | Electricity tax | 100 | No |
| | Inheritance and gift tax | 100 | Tax schedule, threshold, and tax credits |
| | Capital transfer tax | 100 | Tax rates and tax credits |
| | Tax on gambling | 100 | Tax rates, tax base, allowances. |
| | Vehicle registration | 100 | Tax rates |
| | Hydrocarbons retail sales | 100 | Tax rates |
| Tax sharing | VAT | 50 | No |
| | Excise taxes | 58 | No |
| | Personal income tax [1] | 50 | Tax schedule, tax credits |

Note [1]: Regions can set the rate schedule provided the schedule is progressive.
Source: Ministry of Budget, Barclays Research

For historical reasons, the Basque Country and Navarre have a separate financing system ("*régimen foral*"). Both regions enjoy considerable freedom in establishing and administering personal and corporate income taxes. Most expenditure responsibilities have been devolved; the only notable exception is pensions, which are still administered by the central social security system. Both regions contribute to the central government with a fixed share of GDP for the general expenditures that remains in the hand of the central government, including defense and nationwide infrastructure.

At the heart of the financial discussion between the Catalonian and the central government is the concept of inter-regional solidarity. Article 2 of the Spanish Constitution guarantees the principle of solidarity, which sustains the state of autonomy of the Spanish regions ("The Constitution is based on the indissoluble unity of the Spanish nation, common and inseparable fatherland of all Spaniards, and recognises and guarantees the right of autonomy of the integrated nationalities and regions and the solidarity between them"). The financing system of the Spanish regions is based on the principle of solidarity – defined as an equivalent level of services, unrelated to individual fiscal capacity, that will be provided in each of the regions.

In order to reduce inter-regional economic imbalances and to implement the principle of solidarity, in December 1990, the so-called "inter-territorial compensation fund" (Fondo de Compensación Interterritorial) was established. The compensation fund's resources were earmarked for investments, which would be distributed by the central government to regions with lower income. In addition, several inter-regional transfers have also been developed over time. The so-called "relative income fund" was designed to level the relative wealth of the regions. A "fund for mitigating a scarce population density" was further set up. A "growth modulation" was also introduced to assess which regions have per capita income of less than 70% of the national average and the "inter-territorial compensation funds" were established to promote convergence of income levels across the regions.

*Several regions, including Catalonia, have been underfunded under the current financing system*

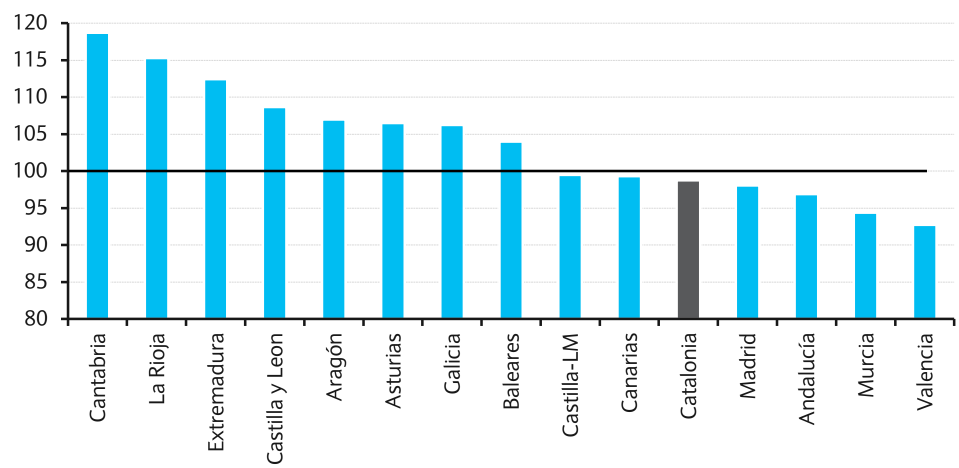
Assessing the fairness of the current regional financial system (or lack of thereof) has been an extraordinarily politically charged discussion. Several regions have complained, including Catalonia, of unfair distribution of financing given the recent population trends within Spain. The most recent assessment on this complex issue was conducted in September 2014 by Fundación de Estudios de Economía Aplicada (FEDEA). The study calculates the "adjusted" fiscal balances between regions, where the adjustment factors allow for homogenous competences and equal fiscal effort under the new financing regime of 2009. Such adjustments permit comparisons across regions in terms of financing per capita. The results show that Catalonia was underfunded in per capita terms during 2002-12, but the underfunding was not very large: in 2012 it was about 1.2% below the average. The region with the largest negative gap in 2012 was Valencia, 7.3% below the average, and the region that benefited most was Cantabria, 18.7% above the average (Figure 11).

*The central government may open the debate of regional finances ahead of the regional elections*

In our view, it is reasonable to expect the government to open a discussion of regional finances ahead of the regional and national elections in 2015. There appears to be some room to improve the financing of Catalonia, and this may reduce the pro-independence drive. But the scope for improvement in Catalonia's finances is limited, in part because the size of the fiscal imbalances is not very large, especially for Catalonia. More importantly, it will require some income redistribution across regions. With the regional elections scheduled for May 2015 (likely to be scheduled earlier), it will be politically very complicated to negotiate a new financing framework that would make several regions worse off.

FIGURE 11

**Adjusted regional fiscal balances, 2012 (ex-Basque Country and Navarre)**




Source: Fedea, Barclays Research

## Next steps for Spain and Catalonia

Given the size of Catalonia's economy and the non-negligible chance of independence over the medium term, it is somewhat surprising that markets have largely remained calm about this possibility. Perhaps ECB's promise to do "whatever it takes" to support the euro area may be a dampening factor. Nonetheless, Spanish banks headquartered in Catalonia (eg, Caixabank and Banco Sabadell) have experienced some volatility. When the regional government signalled that it intended to carry on with some kind of independence vote, credit spreads of Caixabank and Sabadell widened and somewhat underperformed the other Spanish banks in the region. For example the senior unsecured bonds of La Caixa/Caixabank widened 10-20bp, while bonds issued by BBVA and Santander were broadly stable.

## Next political steps

Although uncertainty remains elevated, we consider the following steps as likely. First, the central government may launch discussions in the coming months to modify the current financing system, with the view to allocating more financial resources to Catalonia. As we discussed above, Catalonia, along with several other regions, has been slightly underfunded in recent years. Second, the central government could be open to negotiations on a limited constitutional change that would enable a larger devolution of powers or even open a way towards a legal referendum at a much later stage. While there has been some speculation in the local media about these options, so far they are not officially under discussion.

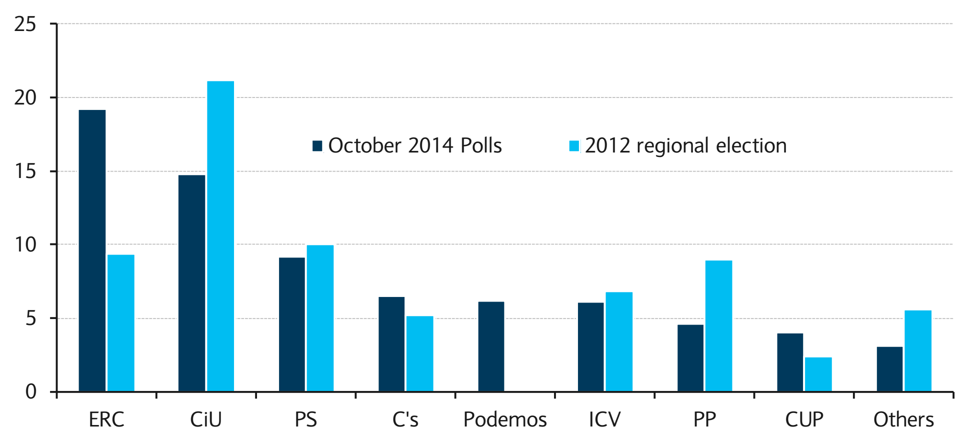
As for the pro-independence regional parties, a very likely path is that they could push for early regional elections, which are due no later than end May 2015 (likely to be held between December 2014 and May 2015; general elections are due by end 2015). The regional elections would serve as a barometer for the support of voters over Catalonia's break up from the rest of Spain. The governing party, CiU, has offered to ERC (which leads in most recent polls) and to other pro-independence parties to form a common pro-independence front. ERC has so far rejected this proposal. These are, however, the first regional elections with a clear divide in the political parties between those openly declaring themselves as pro-independence and those that are unionist. Hence, the regional elections might de facto be seen as a referendum on Catalonia's support for independence.

*Pro-independence parties lead in the polls ahead of the regional elections, which are due no later than May 2015*

A fast-track path to Catalonia's independence cannot be dismissed. One scenario could be the ERC, the more radical pro-independence party, winning more than 50% of the vote in the regional election, followed by a referendum and a declaration of independence. We cannot entirely dismiss this scenario, as the latest poll (Metroscopia, Figure 12) put ERC ahead of other parties with 19.2% of the vote (versus 9.4% of the vote in the 2012 election). CiU, the current government party which has also signalled its support for independence, would get 14.8% (21.2% in the 2012 election) and the Socialist party 9.2% (10% in the election). This poll also shows that an additional 10% would go to pro-independence ICV (6%) and CUP (4%). In sum, of the 74% declared vote intention (ie, 26% did not declare

FIGURE 12

**Voter preference shifting towards pro-independence (% votes)**




Source: Metroscopia

support for any specific party), a majority of the votes could go to pro-independence parties (44%). The central government party, the Popular Party, would only come seventh in vote intentions and would get 4.6% of the vote (9.0% in the 2012 elections). A likely outcome for the regional election appears to be a coalition of pro-independence parties, which are likely to negotiate both an improvement of the financing system for Catalonia and a constitutional change that would increase regional autonomy and could permit a referendum on independence in the future.

## The economic implications of Catalonia's independence

*The EC has indicated that Catalonia will have to exit the EU in the event of a break up – the impact could be significant as the majority of Catalonian exports are with the EU*

Catalonia is highly integrated with the rest of Spain and Europe through very close economic and financial links. Currently c.73% of its goods exports go to the EU (ex-Spain); if we include other regions of Spain, exports to the EU are well over 90% of the total. The European Commission has clearly stated that Catalonia would be forced to exit the EU (and the euro area) if it breaks from Spain and would need to reapply for membership; a process that could take years.

The largest financial institutions based in Catalonia are strongly linked to Spain through their branches and revenue sources and could shift their headquarters to Spain in the event of a break up. If they remain in an independent Catalonia outside the EU, these banks would lose access to ECB's liquidity and lender-of-last-resort facilities. These banks may also prefer to be supervised by the European SSM rather than by a local Catalonian supervisory authority.

The lion's share of the two largest Catalonian-based banks' – Caixabank and Sabadell – businesses is in Spain's other regions. Nonetheless, a significant exposure of their real estate and financial revenues would likely remain in Catalonia. By number of branches, Caixabank has a market share of about 35% in Catalonia and Sabadell a 13% share (with a slightly higher, 15% share of business volumes). Although BBVA is not headquartered in Catalonia, it does have a market share of close to 25% based on branches following its recent acquisition of Catalunya Banc.

The impact of independence on Catalonia's growth prospects is difficult to quantify. The fate of an independent Catalan state would depend crucially on whether the EU softens its stance and allows free trade in goods, services, capital and labour with Catalonia. It would also depend on the ability of Catalonia to retain the euro and access to the Eurosystem's liquidity and lender of last resort facilities. Migration flows also could become an important factor, as well as the stability of the deposit base.

We think that the European Commission's hard stance against independence is driven by Brussel's interest to avoid setting a precedent. If Catalonia were to separate from Spain but stay in the EU and the EA, it would open the door to other potential secessions in other countries such as Belgium, where the Flemish nationalists are now in the federal government. If Brussels decides to exclude Catalonia from the EU, it means Catalonia would the facto be out of the euro area as well. The exit would likely take time, and would fuel market volatility and make it difficult for Catalonia to access capital markets.

*Rating agencies would likely exert further downward pressure under independence*

In our view, rating agencies would likely exert further downward pressure on Catalonia in an independence scenario – two of the three largest agencies already rate Catalonia as sub-investment grade. Further downgrades would make market access more challenging and costly. With public debt 9.5pp of GDP above the Spanish regional average, independence could push Catalonia's overall public debt well over 100% of GDP, especially as GDP is likely to shrink. About 90% of its public debt would be owed to the Spanish sovereign: Catalonia's 18.9% share of Spain's public debt plus FLA and FFPP loans (discussed in detail earlier).

## How Spain and Europe would be impacted?

### The rest of Spain and Europe, could also suffer losses in a breakup scenario

*If independence risks increase, Spain and Europe will likely be under pressure as "redenomination risk" could also increase.*

It is not clear what decision an ERC-led government would take over Catalonia's public debt, especially the part of that debt owed to Spain. There would be complex negotiations over the split of assets and liabilities. But we think that investors would likely assign some risk of default by Catalonia on its liabilities, which are mainly held by the Spanish sovereign, as we discussed earlier. In the event of default, Spain might have to assume most of Catalonia's public debt, which would push overall sovereign debt in Spain to over 120% of GDP, and the public deficit would remain far above the level that would ensure fiscal solvency. Catalonia is also an important market for Spanish firms and financial institutions; therefore, a deep and protracted downturn in Catalonia could hurt Spain's growth prospects. Markets would likely demand a higher risk premium to fund the Spanish sovereign, and as a result, the effort necessary to restore primary balance solvency would increase – Spain's primary balance is still c. 4pp of GDP away from a debt-stabilising level.

Other European countries and especially the periphery would likely experience volatility and spread widening. If Catalonia were to be forced out of the euro area, it would create the precedent of a country leaving the euro. This would probably imply the return of the "redenomination" risk. To stabilise adverse dynamics, the ECB might need to intervene, either in the context of QE on EGBs or under its OMT programme. That could happen at the same time when the legality of the OMT programme is under revision by the German court of justice (the ECJ is scheduled to rule next summer, opening the door for Karlsruhe to have a ruling on Germany's participation in OMT). Therefore, triggering the OMT would probably be delicate. Even if the ECB may launch QE on EGBs and this would mitigate risks, independence would nonetheless generate market volatility and higher spreads in some parts of the EA. it is possible that Italy would be back under the spotlight, especially if northern pro-independent support benefits from a Catalonian breakup. In sum, economic logic favours an outcome that keeps Catalonia in Spain possibly with enhanced financial resources and self-government. Such a solution would not be easy as other regions would likely lose some financing that would be channelled to Catalonia and some other regions. But the alternative could prove disruptive for Catalonia, Spain and Europe.

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