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Summary

Government rejects Turkey's request to extradite two writers.

Catalan president fails to clarify independence bid, raising prospect of direct rule of the region.

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Spain, third EU country with most growth in risk of poverty

Foreign Policy

Government rejects Turkey's request to extradite two writers

The government turned down a request to extradite two Turkish writers, following an Interpol warrant initiated by Ankara.

Hamza Yalçın, a Swedish-Turkish national, was arrested in Barcelona in August while on holiday and Doğan Akhanlı, a German-Turkish national, in Granada. Both were released and told to stay in Spain pending decisions on their extradition.

The Turkish government accused Yalçın, a journalist who has lived for years in exile in Sweden, of terrorism and of insulting President Recep Tayyip Erdoğan. He edits a Turkish-language online publication, *Odak*, which is critical of the Ankara government.

Akhanlı has lived in Germany since 1991. He said Turkey wanted him for his books on the mass killings of Armenians during World War One and on the rights of Turkey's Kurdish minority.

Reporters without Borders accused the Turkish government of using the state of emergency imposed following last year's attempted coup against Erdoğan to suppress criticism of the government. Dozens of journalists have been detained.

Turkey ranks 155 on Reporters Without Borders' latest press freedom index, below Belarus and the Democratic Republic of Congo, after dropping four places from its 2016 ranking.

Domestic Scene

Catalan regional President fails to clarify independence bid, raising prospect of control of the region

The Catalan leader Carles Puigdemont ignored the government's ultimatum for clarity on whether he was seeking secession and stuck to his decision to keep his declaration of independence 'in suspension' pending the outcome of a dialogue. The likelihood of Madrid taking control of the autonomous region now looked more certain.

Prime Minister Mariano Rajoy had asked for a straight yes-or-no answer by 10am Madrid time on 16 October. This followed Puigdemont signing a declaration of secession from Spain on 10 October but then immediately halted its implementation in the hope of starting negotiations with Madrid. In the event of opting for an independent republic Puigdemont had been given until 19 October to revoke the declaration or face direct rule from Madrid.

In his letter to Rajoy, Puigdemont reiterated his assertion that Catalonia had won the right for independence after 2.3 million (43% of the electorate) voted in an illegal referendum on 1 October, 90% of them in favour of secession and in the face of police batons and rubber bullets. Independence supporters made much of the alleged 800 people injured, though only four were hospitalised, in images that shocked the world.

'Our proposal for dialogue is sincere, despite everything that has happened, but logically it's incompatible with the current climate of growing repression and threats', Puigdemont wrote.

Soraya Sáenz de Santamaría, the Deputy Prime Minister, said 'dialogue has to be carried out within the law, with the maximum possible clarity and in the congress where all Spaniards are represented'.

The referendum was unconstitutional, as it required the permission of the national parliament and the central government. It now looked likely that Rajoy would follow through on his threat, supported by two of the opposition parties, the Socialists (PSOE) and the centrist Ciudadanos, and activate, in an unprecedented move, Article 155 of the 1978 Constitution to suspend Catalonia's autonomy. The two sides are at the moment so entrenched that a dialogue is a non-starter.

The tougher stance was signalled with the jailing of the first senior secessionist figures since the referendum. A court ordered Jordi Sánchez, the head of the organisation Catalan National Assembly (*Assemblea Nacional Catalana*, ANC), and Jordi Cuixart, the leader of the cultural institution Òmnium, to be held without bail pending an investigation for alleged sedition.

The Popular Party, the Socialists and Ciudadanos hold 254 of the 350 seats in the national parliament (68.6% of votes). Pedro Sánchez, the Socialist leader, swung his support behind Rajoy in return for a commitment to set up a commission to study constitutional reform, something the PP has been loath to do.

Such was the depth of the crisis that a stern King Felipe VI addressed the nation on 3 October and accused the Catalan government of seeking to break 'the unity of Spain'. His televised address recalled that of his father, King Juan Carlos, in 1981 when he faced down an attempted military coup.

'Faced with this extremely grave situation, which requires the firm commitment of all to the common interest – it is the responsibility of the legitimate state powers to ensure constitutional order and the normal functioning of the institution, the validity of the rule of law and the self-government of Catalonia, based on the constitution and its statute of autonomy', said King Felipe.

The King's remarks probably encouraged more people to turn out on 8 October in Barcelona in favour of the unity of Spain. Some 400,000 people protested against independence, many waving or wrapped in the red and yellow Spanish flag, in contrast to the *esteladas*, the starred flag of Catalan independence.

The protest took place two days after the 83rd anniversary of the proclamation of a short-lived Catalan state by Lluís Companys, the President of the Generalitat (the Catalan government), a totemic figure who was arrested by the Gestapo, handed over to the Spanish police and executed on 15 October 1940, a year after General Franco won the 1936-39 Civil War. His death is publicly commemorated every year.

This was the first time the so-called 'silent majority' in Catalonia voiced its concerns en masse. While polls show that some 80% are in favour of a referendum, only around 40% want independence. Until now, the anti-independence bloc has been nowhere near as organised as those in favour of secession.

Puigdemont's ambiguous stance angered both 'unionist' parties as well as the anti-capitalist CUP, the most radical element in a pro-independence movement that is not monolithic. The CUP felt let down, as it wanted Puigdemont to fulfil his promise of declaring independence within 48 hours of a successful 'yes' vote.

The CUP's 10 seats in the Catalan parliament won in the 2015 election (the third in five years) enable the conservative nationalist Junts pel Sí, in an unholy alliance with the CUP, to govern, but the CUP could withdraw its support and force an early election in the region (see Figure 1). Rajoy could reportedly also call for an election.

Figure 1. Results of Catalan election (seats, votes and % of votes)

	Seats	Votes	% of votes
Junts pel Sí ('Together for Yes')	62	1,620,973	39.6
Ciutadans	25	734,910	17.9
Catalan Socialists	16	522,209	12.7
CSP (1)	11	366,494	8.9
Popular Party	11	348,444	8.5
CUP (2)	10	336,375	8.2

(1) Catalunya Sí que es Pot: several leftist parties including Podemos and Initiative for Catalonia-Greens.

(2) Pro-independence Popular Unity Candidacy.

Source: Catalan government.

The discourse in the pro-independence camp is somewhat surreal, as highlighted by the divergent treatment given to two people, Arnaldo Otegi, a jailed supporter of the terrorist group ETA who wants an independent Basque country, and the well-known Catalan singer-songwriter Joan Manuel Serrat, an iconic figure censored by the Franco regime for his protest songs. While Otegi was guest of honour at the 11 September Catalan national day, Serrat was labelled a traitor and fascist for questioning the referendum.

Like some kind of millenarian movement, secessionists believe that an independent Catalonia will be better off on its own than staying in Spain. Not even the significant exodus of companies (see the next item) or repeated warnings that an independent state would no longer form part of the EU or the euro zone and would have to negotiate its re-entry has changed the views of those who see greater economic prosperity in an independent state.

The roots of stand-off with the central government can be traced back some 300 years to the War of Spanish Succession, but the present-day independence movement began in 2006 when parts of a new statute of autonomy agreed with the central government and approved in a referendum in Catalonia was successfully challenged by the Popular Party in the Constitutional Court (see Figure 2).

Figure 2. Timeline of the collision between the Catalan and central governments

Date	Events
8 August 2006	Catalan Parliament approves new autonomy statute following a successful referendum in the region and ratified by the Congress and Senate in Madrid.
26 June 2010	Constitutional Court rules there is no legal basis to recognise Catalonia as a nation and that the Catalan language should not take precedence over Castilian Spanish. This followed a challenge by the Popular Party, the ombudsman and five regional governments.
10 July 2010	Massive demonstration in Catalonia against the Constitutional Court's ruling.
20 September 2012	Catalan Premier Artur Mas meets Prime Minister Mariano Rajoy in bid to obtain a fiscal pact. Fails and calls an early election in the region.
25 November 2012	Mas's CiU party wins the election but with 12 fewer seats in Parliament. He remains Premier thanks to the support of the openly pro-independence ERC, which captures 11 more seats.
9 November 2014	Mas defies the Constitutional Court and holds an informal, non-binding referendum on secession. More than 80% in favour but only 2 million out of an estimated 5.4 million eligible voters took part.
21 November 2014	The public prosecutor brings charges against Mas and two of his Ministers for holding the referendum.
1 September 2015	Ruling Popular Party enables the Constitutional Court to sanction those in elected positions who do not comply with its rulings.
28 September 2015	Pro-independence alliance Junts pel Sí wins Catalan parliamentary election and teams up with anti-capitalist CUP. Refuses to keep Mas as Premier. Pro-independence parties win 48% of the vote and 'unionist' parties 39%.
9 November 2015	Catalan Parliament approves declaration of sovereignty and the right to decide.
2 December 2015	Constitutional Court annuls the declaration of sovereignty and right to decide.
10 January 2016	Carles Puigdemont becomes new Catalan Premier, with the goal of calling a legally-binding referendum on independence.
1 August 2016	Constitutional Court suspends independence roadmap approved by the Catalan Parliament.
28 September 2016	Puigdemont announces an independence referendum in September 2017 with or without Madrid's permission.
17 October 2016	Public prosecutor brings charges of disobedience against Carme Forcadell, President of the Catalan Parliament, for allowing the pro-independence roadmap to be put to a vote in July.
14 December 2016	Constitutional Court blocks plans to hold an independence referendum.
13 March 2017	Artur Mas, former regional President of Catalonia, and three of his Ministers banned from public office over the 2014 non-binding informal vote.
6 September 2017	Catalan parliament fast-tracks a referendum law and the regional government formally calls the 1 October referendum on secession from Spain.
20 September 2017	Catalan government officials arrested over links to organising the unconstitutional referendum. Central government announces it would partially take control of Catalan government finances. Police search printers and seize ballots and propaganda material.
1 October 2017	Catalan officials said that almost 2.3 million people participated in the referendum (40% of voters eligible for the plebiscite), 2 million of them voting 'yes', a similar turnout for the informal consultation in 2014.
10 October 2017	Puigdemont declares independence but immediately suspends it in search of dialogue.
16 October 2017	Puigdemont ignores Madrid's ultimatum on clarifying whether he has actually declared independence and reiterates his call for talks.

Source: the author.

The Economy

700 Catalan companies vote with their feet

Some 700 Catalonia-based companies and banks, including some big names such as CaixaBank, Spain's third-largest bank, and the cava producer Codorníu are moving their legal headquarters because of the uncertainty generated by the regional government's declaration to secede from Spain and hence cease to be part of the EU and the euro zone.

The move, expected to gather pace, will deal a heavy blow over time to the finances of one of Spain's richest regions and dents Catalonia's much-vaunted image as a place for business and a magnet for foreign investment.

Six of the companies that are relocating form part of the Ibex-35, the benchmark index of the Madrid stock market (see Figure 3). Multinationals such as Volkswagen, which owns a Seat plant near Barcelona making 2,000 cars a day, are keeping a close watch on the situation.

Figure 3. Main companies based in Catalonia that have moved their legal domicile

	New location of legal domicile
Ibex-35 companies	
CaixaBank (third-largest bank)	Valencia
Banco Sabadell (fifth-largest bank)	Alicante
Gas Natural (major energy supplier)	Madrid
Abertis (infrastructure)	Madrid
Cellnex (telecoms)	Madrid
Colonial (real estate)	Madrid
Continuous market	
Catalana Occidente (insurance)	Madrid
Naturhouse (nutrition)	Madrid
Dogi (textiles)	Madrid
Oryzon (biotech)	Madrid
Applus (testing, certification)	Madrid
eDreams Odigeo (online travel agency)	Madrid
Service Point (printing, document management)	Madrid
Alternative Market companies	
Lleida.net (electronic notification)	Madrid
Eurona (satellite broadband)	Rivas-Vaciamadrid
Unlisted companies	
Torraspapel (paper)	Madrid
Agbar (water)	Madrid
Grupo Planeta (publishing)	Madrid
Bimbo (bakery products)	Madrid
Codorníu (cava)	Haro (La Rioja)

Source: Mercantile Registry, Economy Ministry.

CaixaBank, the main financial institution in Catalonia, has played a major role in the region's economy and as a sponsor of cultural and social programmes through its foundation. It has close to 40% of the total deposits in Catalonia and Sabadell 15%. Like CaixaBank, Banco Sabadell dates back to the 19th century. Both banks have also moved their tax residence.

The banks are moving their legal, though not corporate, headquarters in order to protect the interests of depositors and shore-up confidence. The banks need to remain within the euro zone to maintain regulatory continuity and in order to continue to access the European Central Bank's liquidity mechanism. The branch managers of both banks took to the phone to reassure customers that their investments (deposits, mutual and pension funds) were safe.

An independent Catalonia would have to re-apply for EU and euro-zone membership. Until that happened, and assuming it would, the border between Spain and Catalonia would become an external border of the EU and the Schengen zone of passport-free travel.

The shares of the two banks took a knock on 4 October three days after the illegal referendum on Catalan independence when 90% of those who voted were in favour of secession. Sabadell's share price fell 5.69% and CaixaBank's 4.96%. The Ibex-35 fell 2.85%, the largest one-day fall since the UK decision in June 2016 to leave the EU, to below 10,000 for the first time in some six months and far from this year's peak of 11,250 reached in May. By 16 October the index had recovered to 10,181.

The central government approved a decree on 6 October that makes it easier for companies to transfer their legal and tax base out of Catalonia without having to hold a shareholders' meeting. CaixaBank had a legal vacuum that it had not plugged as its statutes require such a meeting.

Both the Bank of Spain and the IMF issued warnings about the economic consequences of Catalonia creating an independent state. The central bank said the 'political tensions' in Catalonia could 'eventually affect the confidence of [economic] agents and their spending decisions and financing conditions'. For the moment, the government and the IMF (in its latest forecast) forecast GDP growth of more than 3% this year.

Catalonia plays a key role in the Spanish economy. The region's population of 7.5 million (16% of the total) generates around one-fifth of Spain's GDP and one quarter of total exports and received 18 million of Spain's 75.3 million tourists last year. Its GDP (€224 billion in 2016) is larger than Portugal's.

A significant part of Spain's progress since the end of the Franco dictatorship in 1975 and the smooth move to democracy and a fully-fledged market economy is due to Catalonia (see Figure 4).

Figure 4. Key indicators of Spain, 1977 and 2017

	1977	2017
Population (million)	36.2	46.4
Immigrant population (1)	159,924	4,549,858
Average life expectancy (years)	74.1	82.8
Fertility rate	2.65	1.3
Nominal per capita income (€)	1,657	25,028
Inflation (%)	26.3	1.5
Public debt (% of GDP)	13	100
University graduates (% of population over the age of 16)	3.6	28.2
Illiteracy rate for those over age of 16 (% of population over 16)	9.0	1.7
Illiteracy rate for those over age of 65 (% of population over 65)	30	5.4
Female economic activity rate (% of women over age of 16)	28	53
Gross foreign direct investment inflow (US\$ mn)	608	26,727
Exports of goods and services (% of GDP)	13.3	33.1

(1) Excludes those who have taken out Spanish nationality (660,000 between 2011 and 2015).

Source: the author.

The Catalan crisis is paralysing investment projects, affecting tourism (hotel bookings in Barcelona for October are down by more than 20% and some cruise ships stopped calling in at the city's port) and produced outflows from Spanish equity funds. Redemptions amounted to US\$229 million in the week to 4 October, the largest outflow in a week since the 2014 informal poll in Catalonia when 80% of voters supported an independent state. The central government has postponed presenting to parliament its bill for the 2018 budget.

A €16 billion take-over of Barcelona-based highway management company Abertis by Italy's Atlantia, which is believed to be close to approval, could be delayed due to the political uncertainty in the region. The sale of a stake in the partly nationalised Bankia was put on hold.

Rating companies Standard & Poor's and Fitch Ratings placed Catalan debt on negative watch, signalling an increased chance of a downgrade.

The yield spread between 10-year Spanish government bonds and the ultra-safe German debt reached its highest level after the referendum since just after the first round of the French elections in April (more than 1.25 pp) and then declined (see Figure 5).

Figure 5. Ten-year government bond spreads

	Yield (16 October, %)	Spread vs bund
France	0.78	+0.41
Germany	0.37	–
Italy	2.03	+1.66
Spain	1.56	+1.19
UK	1.33	0.96

Source: Markets.

Spain, third EU country with most growth in risk of poverty

The share of people at risk of poverty or social exclusion rose from 23.8% in 2008 to 27.9% in 2016, the third largest rise in the EU, according to Eurostat (see Figure 6).

Figure 6. At risk of poverty or social exclusion in the EU, 2008-16 (% of total population)
(1)

	2008	2016
France	18.2	18.5
Germany	19.7	20.1
Italy	25.5	28.7
Spain	23.8	27.9
EU-28	23.4	23.7

(1) This means these people were in at least one of the following three conditions: at-risk-of-poverty after social transfers (income poverty), severely materially deprived, or living in households with very low work intensity.

(2) 2015.

Source: Eurostat.

The highest shares were in Bulgaria (40.4%) and Romania (38.6%) and the lowest in the Czech Republic (13.3%) and Finland (16.6%).

IMF calls for Spanish banks to build on the progress made

Spain's banking system is much healthier following the reforms made in the wake of the bursting of a massive debt-fuelled property bubble as of 2008, which led to the downfall

of a large number of banks and the part nationalisation of Bankia, but needs to keep the reform process moving, according to the IMF's latest report on the financial system.¹

The four key areas where more progress is required are:

- Accelerated clean-up of legacy bank assets.
- Further improvement in bank profitability and capitalisation.
- Rigorous management of interest rates and liquidity risks.
- Reform of the institutional framework for financial oversight.

Spain has 17 'significant' banks, which represent 90% of banks' total assets, one of which, Santander, is a global systemically important bank.

Non-performing loans have come down considerably, but at 70% of their 2013 peak of €210 billion total problem assets (including foreclosed property) remain high.

The IMF says that banks needing additional funds to support their clean-up should raise capital or explore other financing operations. It warns that market discipline will become demanding as Spanish banks turn to tap wholesale funding once the European Central Bank's targeted longer-term refinancing operations (TLTROs) expire in June 2020.

It also says the Spanish financial system is becoming more exposed to contagion risks that need greater oversight and analysis, as a result of the growing cross-border presence of Spanish banks.

The total assets of financial institutions in Spain were 361% of GDP in 2016, down from 404% in 2007. The share of assets abroad rose from 20% in mid-2008 to 45% at mid-2016. Spanish bank subsidiaries have become systemically important in Chile, Mexico and Portugal (see Figure 7).

¹ The full report is available at <http://www.imf.org/en/Publications/CR/Issues/2017/10/06/Spain-Financial-System-Stability-Assessment-45321>.

Figure 7. Significance of Spanish banks for host countries (%)

	Share of bank assets abroad	Share of Spanish bank assets in host countries' banking assets
UK	26.8	3.9
US	15.9	1.8
Mexico	8.9	37.7
Brazil	10.2	10.3
France	3.8	0.8
Portugal	3.5	14.3
Chile	4.2	25.3
Turkey	5.3	11.5

Source: Bank of Spain.

As well as the reduction in non-performing loans, capital adequacy has improved. Regulatory capital to risk-weighted assets rose from 11.9% in 2010 to 14.8% in 2016 see Figure 8).

Figure 8. Financial soundness indicators

	2010	2012	2013	2015	2016
Exposure to construction (€ bn)	422	294	232	175	157
Non-performing (%)	13.5	28.5	37.3	28.3	26.5
Return on assets (%)	0.5	-1.4	0.4	0.5	0.4
Return on equity	8.0	-21.0	5.4	7.1	5.5
Loans to deposits (%)	144.8	132.4	118.3	110.0	105.7
Use of ECB refinancing (€ bn)	70	357	207	133	140

Source: IMF.