



Catalonia's¹ continued push for independence is increasing political uncertainty in the region and raising political noise in the Kingdom of Spain generally. The noise is having an impact, as yields on Catalonia's debt have widened relative to Spanish sovereign debt. DBRS expects the noise level to increase in the weeks leading up to the referendum, which the regional government of Catalonia plans to hold on 1 October 2017 (commonly referred to as "1-O").

Under DBRS's most likely scenario, which is currently factored into the Kingdom of Spain's rating (A (low), Stable), Spain is expected to preserve its unity over the medium-term. This view largely reflects the opposition of the national government to Catalonia's independence and the current legal and institutional hurdles that would impede the regional government's secession plans.

Besides these impediments, DBRS considers that strong economic growth and the rapid reduction in unemployment both in Spain and in Catalonia are likely to reduce support for independence. In addition, in DBRS's view, the new Spanish regional financing system under discussion could alleviate some of the political support for independence in Catalonia going forward.

Renewed push for independence in Catalonia

The push for independence is long standing within Catalonia, but has been re-energized in recent years. With a population of 7.5 million at the end of 2016, Catalonia is the second-most populated region in Spain after Andalusia. The region also has the largest regional GDP in the country at EUR 212 billion (19% of national output), ahead of Madrid.

Events since the recent financial crisis contributed to the reinvigoration of the push for independence. Since 2014, a sequence of political milestones have occurred, including:

Summary:

- **Renewed push for independence in Catalonia.** Pro-independence parties gained momentum during Spain's financial crisis and particularly since their victory in regional elections in 2015. The current regional government of Catalonia plans to hold a referendum on independence on 1 October 2017.
- **The trend in recent opinion polls suggests that support for independence is losing some momentum.** However, should a vote occur on 1 October 2017, pro-independence voters would likely win a majority, given the likely level of voter abstentions.
- **Institutional safeguards support the national government's stance of unity.** These include (1) Spanish constitutional protection; (2) the national government's financing of Catalonia and the strict financial oversight associated with it; and (3) the question of international recognition of Catalonia by institutions including the United Nations, NATO and the European Union.

Date – Milestone	Description
November 2014 – Non-binding consultation	<ul style="list-style-type: none"> - Consultation of Catalanian voters regarding the possible independence of the region. - Results in favour of independence at close to 81% of votes, but with a relatively low turnout at around 37% of eligible voters.
September 2015 – Snap Parliamentary elections	<ul style="list-style-type: none"> - Regional elections won by pro-independence party, Junts per Sí (JxSí) with 62 out of 135 seats in the Catalanian Parliament. - JxSí formed a coalition with the other pro-independence party, Candidatura d'Unitat Popular (CUP; 10 seats), representing 53.3% of the seats and 47.8% of the vote.
October 2015 – Secession process begins	<ul style="list-style-type: none"> - Separatist parties filed a motion in the Catalanian Parliament to begin officially the secession process from Spain and the creation of an independent Catalanian State.

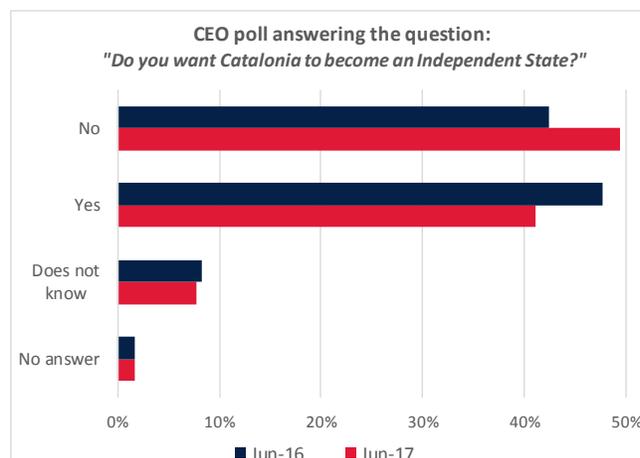
¹ Autonomous Community of Catalonia or Generalitat de Catalunya: "Catalonia".

Date – Milestone	Description
January 2016 – New President takes office	<ul style="list-style-type: none"> - Regional parliament invested Carles Puigdemont (JxSí) as President of the region. - Mr. Puigdemont has been very clear he would follow a roadmap leading to an independence referendum for Catalonia based on the right of self-determination.
June 2017 – Referendum date announced	<ul style="list-style-type: none"> - The regional government of Catalonia announced a referendum to take place on 1 October 2017 to make the region an independent State.
1 October 2017 – Planned referendum date	

The trend in recent opinion polls suggests that support for independence is losing some momentum

Recent polls suggest, however, that support for independence might have slightly waned over the last 12 months. Data from the regional Centre for Opinion Studies (CEO) at the end of June 2017 indicate that 41.3% of Catalans were in favour of an independent State (49.4% against), markedly below the 47.7% in favour recorded in June 2016 (42.4% against).

While any vote, if it occurs on 1-O, would likely see pro-independence voters gain majority, given the likely level of abstentions, DBRS considers that the trend in public opinion may be slowly shifting in favour of retaining the Kingdom of Spain's unity.



Source: Autonomous Community of Catalonia, Centre for Opinion Studies (CEO), DBRS.

Institutional safeguards support the national government's stance of unity

Even if the vote were to take place on 1 October 2017, DBRS does not anticipate a unilateral secession declaration to follow. Such a declaration would be illegal and unconstitutional, given the legal and institutional safeguards in place.

These include (1) Spanish constitutional protection; (2) the national government financing of Catalonia and the associated financial oversight; and (3) the question of international recognition for Catalonia by the United Nations (UN), NATO and the European Union (EU, rated AAA, Stable by DBRS).

1) Spanish constitutional protection

Spain's Constitutional Court, supports the current Spanish government position. The court has ruled in the past that Autonomous Communities cannot unilaterally call for a self-determination referendum under the Spanish Constitution.

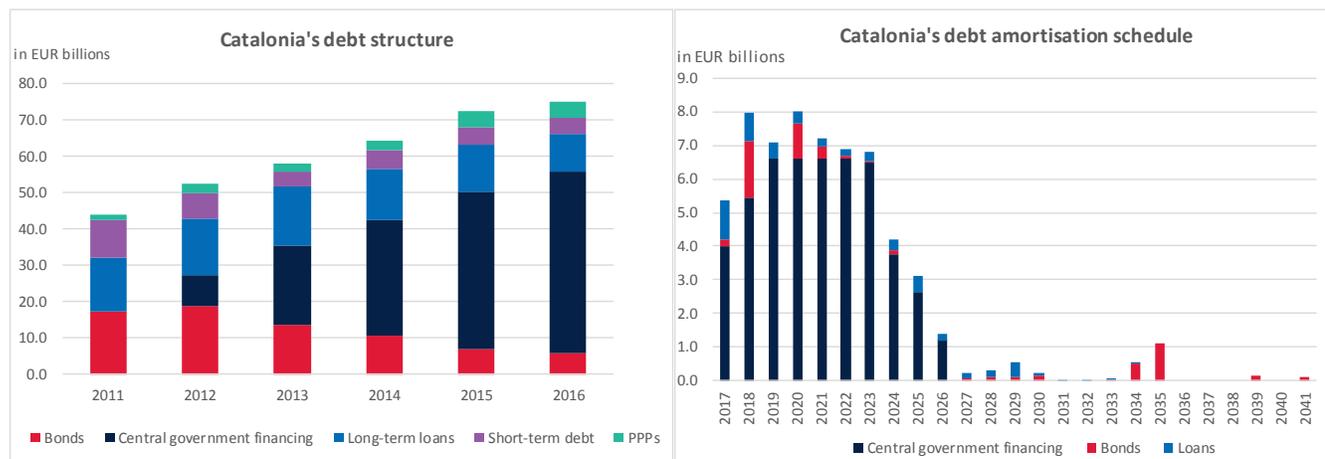
Even if ultimately the Spanish government opened the door to a referendum, which DBRS considers very unlikely, changing the Spanish Constitution to allow the separation of Catalonia would likely prove to be a very demanding and lengthy process. A special majority of the Spanish Parliament is required to change the Spanish Constitution to allow the legal possibility of such an occurrence. DBRS currently views this as highly unlikely given the absence of support for independence by most of Spain's population.

In a scenario where the vote on 1-O does not occur, DBRS expects calls for the independence of Catalonia to continue.

2) The national government's financing of Catalonia and the strict financial oversight associated with it

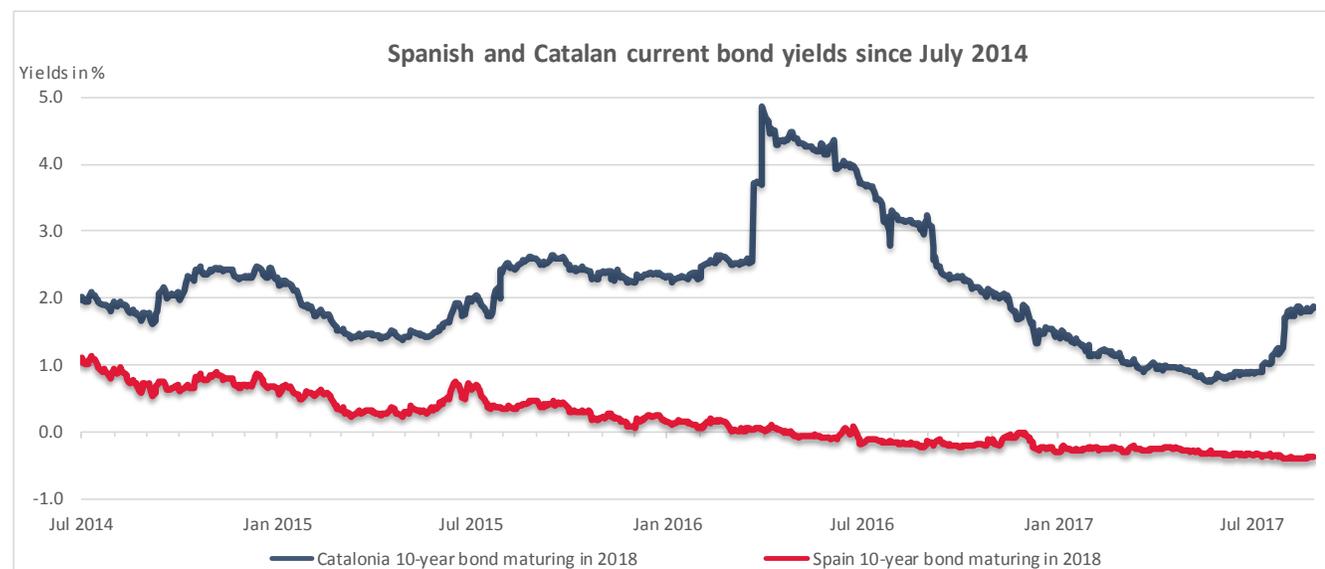
Catalonia's regional finances are already under added scrutiny. On 21 July 2017, the national Executive Committee of the Government for Economic Issues (*Comisión Delegada del Gobierno para Asuntos Económicos*) decided that additional scrutiny on the regional finances needed to be implemented to ensure that no public money was used by Catalonia to finance the organisation of the referendum on 1-O. As a result, the region has to submit weekly financial statements confirming no referendum-related public expenditures.

Failing to comply with these requirements could lead the national government to stop supporting the region financially through its *Fondo de Liquidez Autonómico* (FLA), thereby jeopardising the region's ability to meet its debt obligations. Catalonia has remained largely dependent on the central government's cheap financing since 2012. At the end of March 2017, the financial support provided by the national government to Catalonia represented EUR 50.6 billion, or two-thirds of the regional debt stock (EUR 75.4 billion).



Source: Banco de España, Autonomous Community of Catalonia, DBRS

Recently, yields on Catalonia's debt have increased in the wholesale market, even as the Kingdom of Spain's yields have declined. DBRS expects that the region will continue to benefit from FLA financing, but pressures on regional yields might widen further relative to the sovereign going forward, as the political noise ahead of the referendum increases. This could continue after the referendum if the situation does not normalise. DBRS points out that the region will face large refinancing needs and bond redemptions in 2018, with total refinancing needs of around EUR 8 billion, of which EUR 1.7 billion corresponds to three bond maturities that DBRS expects to be largely met by FLA financing.



Source: Bloomberg data extracted on 29 August 2017, DBRS

3) The question of international recognition for Catalonia

DBRS anticipates that international recognition of Catalonia as a separate and independent State by the UN, NATO and the EU would be limited. Under current circumstances, a Catalan unilateral declaration of independence following an unconstitutional referendum would raise the question of international recognition. On the basis of Spain's right to maintain its territorial integrity, recognition by the United Nations of an independent Catalonia and subsequent recognition by other countries and institutions, such as the EU, currently seems highly unlikely.

In the past, officials from the European Commission mentioned that a new, independent State, would become a third country with regard to the EU and would need to re-negotiate its accession to the institution to become a member. DBRS points out that under article 49 of the Lisbon Treaty, new EU membership requires approval from all existing members, including Spain. Given the current position of the Spanish government, and the illegal and unconstitutional character of the 1-O referendum, such approval appears highly unlikely.

In addition, NATO's representatives also mentioned referring to a planned Scottish referendum following the Brexit vote that joining the alliance would necessitate Scotland to legally split from the United Kingdom (rated AAA, Stable by DBRS), and be accepted by all NATO members as a new independent State. The fact that Catalonia's planned referendum is unrecognised by the Spanish central government and Spain is a member of NATO, would prevent, in DBRS's view, NATO's recognition of Catalonia.

Conclusion and DBRS's view

While the political situation is fluid with continuous uncertainty at least until the next regional Parliamentary elections in November 2019, DBRS's baseline scenario is that of continuity for the Kingdom of Spain.

DBRS also believes that the Catalanian population's push for independence might further ease over the short to medium term, reflecting:

- The continued strong economic growth and unemployment reduction in Spain and Catalonia;
- The progress in the discussions concerning a revision of the regional financing system, which could be more beneficial for Spanish regions and Catalonia;
- The investments of EUR 4.2 billion in Catalonia announced in March 2017 by the Spanish Prime Minister, particularly for transport infrastructure for the 2017-20 period;
- What appears as a more open stance on acknowledging regional differences at the national government level.

Nicolas Fintzel
Vice President
Global Sovereign Ratings
+44 203 356 1531
nfintzel@dbrs.com

Javier Rouillet
Assistant Vice President
Global Sovereign Ratings
+44 207 855 6686
jrouillet@dbrs.com

Nichola James
Co-Head of Sovereign Ratings
Global Sovereign Ratings
+44 203 356 1527
njames@dbrs.com

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DBRS, Inc. | 140 Broadway, 35th Floor, New York, NY, USA 10005 | TEL +1 (212) 806 3277 | www.dbrs.com