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EUROPEAN POLITICS: CATALONIA, GERMANY, AUSTRIA

Berenberg Macro Flash

CATALONIA: FIRST SIGNS OF A RETURN TO REASON?

Madrid apologises for the excessive use of police force during the Catalan referendum, hundreds of thousands of Spaniards take to the streets to demand a dialogue, first cracks appear between the Catalan nationalists: the newsflow over the last few days offers some hope that the conflict about Catalonia can be defused within a few weeks. Unfortunately, the bitter standoff between the two major players in the drama still continues. Spain's prime minister Mariano Rajoy and the Catalan regional leader Carles Puigdemont both took an uncompromising stance in media interviews over the weekend. It may first get worse before it gets better.

By and large, the near-term outcome seems clear, in my view: the Catalan regional government will have to back down. In calling a referendum that violates the Spanish constitution for a cause backed by only half of the Catalan population, the authorities in Barcelona have miscalculated in two major ways:

1. The Catalan supporters of independence are mostly ardent pro-Europeans, like the supporters of the Scottish SNP. However, their hope that the EU would intervene on their behalf was always misplaced. The EU is essentially a club of its member states, not a club of regions or other entities within the member states.
2. Barcelona has underestimated its economic vulnerability. In theory, an independent Catalunya could be a viable country within the EU and the euro after an amicable divorce. It is among the most attractive and dynamic regions of Europe. But a prolonged standoff during a contested divorce could be an economic disaster for the region. For practical purposes, Catalonia cannot become independent against Madrid.

Last week's decision of the top two Catalan banks to shift their headquarters to other parts of Spain is just a foretaste of the calamities that could befall Barcelona if it continues to defy the Spanish constitution. That Madrid may suspend Catalonia's autonomy according to Article 155 of the Spanish constitution may only be part of it. Just imagine what might happen to public services in Catalonia if Madrid were to order banks to freeze the accounts of the Catalan regional government and all other public institutions in the region that do not abide by the Spanish constitution. An implicit risk that Spain might withdraw lender-of-last-resort protection from any bank that does not cooperate may hit the region harder than any use of the national police. While the left-wing nationalists from the CUP may not care and even relish an escalating confrontation, most pro-independence forces in Catalonia come from the moderate centre-right in economic terms. As much as they would like to be independent, most of them probably do not want their region – or their own businesses – to go bust in the process.

The Catalan regional parliament may first declare independence by a wafer-thin majority (possibly on Tuesday evening) before the Catalan side fractures eventually. Sadly, a futile declaration of independence would escalate tensions without contributing to a viable solution.

For the long-term outlook, the real question is whether or not Madrid tries to crush the Catalan pro-independence forces before it starts a dialogue – or starts to talk soon. A hard line from Madrid would probably prevail near-term. It would carry two major risks, though. First, the resulting bitterness may strengthen the radical Catalan parties over time even if the Catalan pro-independence forces lose now. Second, it could undermine Rajoy's minority government in Madrid. Rajoy may need the support of the Basque nationalists to pass a budget and govern effectively. In a best case scenario, Madrid and Barcelona



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would soon agree to revive the autonomy deal that foundered in the constitutional court in 2010. With some amendments to take care of the court's objections, the majority of Spaniards including the Catalans would probably approve such a deal on enhanced autonomy.

In response to the Catalan standoff, we reduced our forecasts for Spanish GDP growth in Q4 2017 and Q1 2018 from 0.7% to 0.6% qoq in our [Forecasts at a glance](#) last Friday. That takes the growth forecast for Spain in 2018 from 2.9% to a still solid 2.7%

GERMANY: A FIRST STEP TOWARDS JAMAICA

As the first step towards forming a new government, chancellor Angela Merkel yesterday defused the conflict about migration policy between her CDU and the Bavarian CSU branch of the centre-right. The outlines of a solution have been obvious for at least a year: CDU and CSU agree to adjust the rules if required to prevent a renewed rise in the inflow of those who claim asylum or refugee status beyond 200k per year without setting a legally dubious hard cap, which the CSU has demanded. That Merkel and CSU leader Seehofer did not strike such an agreement last autumn is one of the reasons why the CDU and, even more so, the CSU lost so many votes at the 24 September election.

The apparent compromise between CDU and CSU opens the door for talks about forming a "Jamaica" coalition between the "black" CDU/CSU, the yellow "liberals" and the Greens. Formal negotiations will probably have to wait until after the state election in Lower Saxony next Sunday. Lower Saxony may not strengthen Merkel's bargaining position for those talks. After the centre-left SPD did so badly at the national election two weeks ago that it ruled out joining Merkel in government again, the party now seems to benefit from a "sympathy with the loser" effect: having been far behind in opinion polls for the state election in Lower Saxony on 15 October, the SPD has now drawn level with the CDU and has momentum on its side.

Once the Lower Saxony vote is out of the way, the tough talks about Merkel's government No. 4 can get under way. It won't be easy. The Greens have already rejected key parts of the CDU/CSU compromise on migration. Whereas we remain optimistic that Merkel will be able to form such a government, including making the compromises which the endeavour would entail, the risk has risen that this may not be done and dusted by Christmas yet but take well into January instead.

AUSTRIA: CENTRE-RIGHT IN THE LEAD – BUT WILL IT FIND A PARTNER?

Ahead of the Austrian national election on 15 October, opinion polls project a victory of sorts for the centre-right "Liste Kurz". With up to 34% of the vote, Kurz is well ahead of the centre-left SPÖ and the right-wing FPÖ. However, strong evidence that a well-paid SPÖ advisor tried to run a dirty tricks campaign against Kurz has made the result even more difficult to predict. The bitter allegations which Kurz and the SPÖ have hurled at each other since the scandal escalated eight days ago seem to have two effects: First, the centre-left SPÖ has lost some support to the right-wing FPÖ. Two of the last three opinion polls now put the FPÖ with roughly 25% ahead of the SPÖ with c23% in the race for the No. 2 position. Second, that Kurz and the SPÖ could form a new government after the election, with the SPÖ switching from its current role as senior partner into that of a junior partner, has become even less likely.

Judging by the polls, the most likely new government would be a coalition between Kurz and the FPÖ as junior partner. While the FPÖ may be reluctant to join Kurz, the policy differences between SPÖ and FPÖ would make this other option difficult for both sides. A third potential alliance, between Kurz, the liberal NEOS and the Greens - akin to the "Jamaica" coalition likely to be formed in Germany - would lack a major-



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ity of seats according to the polls. However, as the polls differ somewhat and have a significant margin of error, we cannot exclude that option.

In any case, forming a new government in Vienna could be as difficult as it is in Berlin. As in Germany, we do not expect a major shift in policies after the vote, except for a potentially even harder line on immigration from outside the EU if the FPÖ were to enter government.

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