Introduction

My name is Calum Crichton. I am a MRes/PhD candidate in Finance at the University of Strathclyde. I am winner of the University of Strathclyde’s Journal of Economic Studies Prize 2012, and winner of Glasgow City Council’s International Financial Services District Award 2013.

In the interests of transparency I will declare a conflict of interest in my submission to the Committee. I live in Scotland and as such I will have a vote in the referendum. After carefully weighing up the political, social, and economic arguments I have decided that I will vote ‘no’ in the referendum as I personally believe this is best for Scotland and the United Kingdom as a whole.

However, I accept and respect the fact that independence may be the democratic will of the Scottish people. In this scenario I would want the Scottish and UK governments to negotiate the best possible deal in the interests of both Scotland and the rest of the UK (hereafter RUK).

Could Scotland Retain Sterling?

The choice of currency is possibly the most important decision an independent Scotland would take. It determines the value of firms’ assets and liabilities, consumer savings and pensions, and will be used as a medium of exchange for every day transactions.

But this choice is not an easy decision. There is a range of options available, each of which has its advantages and disadvantages. I see four basic options that an independent Scotland could consider: retaining sterling as part of a currency union with RUK; unilaterally adopting sterling (or sterlingisation); joining the euro; or introducing a new, separate Scottish currency.

In its White Paper the Scottish Government proposes that an independent Scotland should keep sterling and enter a currency union with RUK. However, by its very definition that would require agreement of the RUK government. Independence would fundamentally transform the relationship Scotland currently has with the Bank of England and the UK Treasury and as such the Scottish Government should not assume that negotiating a currency union would be easy.

The First Minister and other members of the Scottish Government have claimed in public that sterling is an asset which Scotland is automatically entitled to. For example, the First Minister argued in an article in the Mail on Sunday on 5 May

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that because the Bank of England is a government institution serving the entire United Kingdom:

“Sterling is a jointly shared asset which we are entitled to inherit.”

However, I believe this statement misunderstands and misinterprets the status of the Bank of England in UK law and the governance of the UK’s monetary system. As stated in a Scottish Government paper in 2007, the purpose of independence is to bring an end to Acts of the UK Parliament being legislated in Scotland. But this would include those Acts governing the Bank of England, because at present the Bank of England receives its mandate to manage the UK’s monetary system through Acts of the UK Parliament, not the Scottish one.

Upon independence the Bank of England would still be governed through Acts of the UK Parliament and so its responsibility would be towards setting monetary policy for RUK only. At present no legal framework in the UK Parliament exists for sharing its currency system with a foreign country.

Therefore, a direct consequence of independence is that the Bank of England would no longer have either the legal capacity or the responsibility to consider Scottish interests when setting monetary policy. Given that Scotland is the wealthiest region inside the UK based on regional GDP per capita, outside London and the South East of England, it is reasonable to assume that these are currently taken into account.

**Costs and Benefits of a Currency Union**

But this does not necessarily mean that a currency union could not be agreed. It is common to consider the theory of optimal currency areas (hereafter OCA) when assessing whether a currency union should be agreed, an approach both the Scottish Government’s Fiscal Commission Working Group (hereafter FCWG) and the UK Government’s Scotland Analysis paper on currency and monetary policy take, although both consider this from different perspectives. The FCWG starts from the position that Scotland and RUK are already separate countries and argues that they constitute an OCA based on current characteristics (i.e. by assessing data on Scotland as part of the UK).

The Treasury paper, on the other hand, argues that Scotland as part of the UK constitutes an OCA, which is further strengthened by fiscal transfers across the UK to stabilise different economic conditions in different regions – something that would surely end if Scotland were to become independent.

The term ‘optimal’ relates to the ability of each country in the monetary union to limit the costs of sharing a currency and enhance the benefits, which depends on many
factors such as real wage flexibility, labour and capital mobility, and the symmetry of macroeconomic shocks.

Within the current devolution settlement these factors are very similar and so both Scotland and RUK enjoy the advantages of sharing sterling, including low transaction costs for businesses, price transparency, and a lack of exchange rate uncertainty. It could be argued that Scotland benefits from these advantages more so than RUK given that approximately 70% of Scotland’s trade is with RUK, whereas only around 10% of RUK’s trade is with Scotland. Nevertheless, these benefits would continue to be enjoyed by both Scotland and RUK if a currency union was agreed.

However, a currency union also involves costs. But unlike the benefits the costs would not be the same for Scotland and RUK. It is also not clear that the factors currently making Scotland and RUK an optimal currency area would remain.

For example, if there was a substantial rise in oil prices the sterling exchange rate would appreciate, which could harm future export realisation for RUK businesses. Yet at the same time the RUK economy would not benefit from the balance of payments, nor would it receive the tax revenues from these resources. Alternatively, a fall in the oil price would lead to lower tax revenues for Scotland. Without being able to share this shock with RUK the Scottish Government would be more constrained on the fiscal side to stabilise the economy. The consequence is that the economic cycles of Scotland and RUK would diverge over time.

Within the context of a shared monetary system, this means that the Bank of England may have difficulty pursuing other policy objectives for RUK, if, for instance, higher interest rates were required in Scotland to combat inflationary pressures, but lower interest rates were required in RUK to stimulate economic activity.

A more fundamental problem, however, is the risk that would be imposed on RUK taxpayers in the event of another banking crisis. Recent history offers an illustration in this respect. During 2008–2009, for example, the Royal Bank of Scotland (hereafter RBS) and Lloyds Banking Group (hereafter LBG) received emergency liquidity support from the Bank of England which peaked at £36.6 billion and £25.5 billion, respectively. This was accompanied by capital injections from the UK Government of approximately £66.3 billion. UK taxpayers also faced a contingent liability from the banks’ participating in the Asset Protection Scheme, amounting to £457 billion.

While it is true that the objective of central bank and government support is financial stability, independence would make future crisis resolutions extremely complicated.

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10 Indeed RBS had substantial operations in the US and received liquidity support from the Federal Reserve.
International cooperation has typically been limited to liquidity based interventions, with recapitalisations being left as the responsibility of national governments\textsuperscript{11}.

RBS and LBG are both legally headquartered in Edinburgh, and any future support on the scale of 2008 – 2009 would be beyond the financial capabilities of an independent Scotland. But both these institutions have many operations in RUK, so it is possible that any future banking crisis would be jointly managed with the RUK government. However, this would largely depend on the willingness of RUK taxpayers to stand behind Scottish institutions. The implication is that the RUK government would surely demand regulatory oversight of the financial sector in Scotland, which would be problematic given that EU law requires all member states to have their own regulator\textsuperscript{12}.

A further direct risk to RUK is the fiscal position of an independent Scotland. If there was a large oil price shock, or the Scottish government borrowed excessively and overspent, Scottish bond yields could rise and the price of Scottish bonds would subsequently fall. The balance sheet of Scottish banks holding those Scottish bonds would therefore be severely weakened. In that scenario, the Bank of England or RUK government might then need to step in to support those banks. Given that in a sterling-zone 90% of the GDP would originate from RUK, it implies that the ultimate liability of Scottish debt would end up being underwritten by RUK taxpayers.

For the above reasons I believe there are far more advantages to Scotland of a currency union than there would be for RUK, who would incur most of the costs. I cannot foresee any situation where the RUK government would be willing to accept sup-optimal monetary policy to accommodate a foreign country, and nor can I foresee any situation where RUK taxpayers be willing to underwrite the debts of a foreign country.

If the RUK government did agree to a currency union with an independent Scotland I would expect them to demand significant oversight and veto power over Scotland’s fiscal policy and financial services regulation to ensure that the economic structures of the two countries remained broadly similar, and that the risk to their own taxpayers was limited. From an economic viewpoint this would essentially involve Scotland giving up fiscal sovereignty, rendering independence redundant given that the Scottish Government already has a large degree of control over domestic policy.

**Sterlingisation**

In theory Scotland could unilaterally adopt sterling as its currency. This would not require the RUK government’s consent but it means that the Bank of England would not act as a lender of last resort for Scotland.

While this would be easy to implement and be of low cost, I believe it is not a realistic option for an independent Scotland.

\textsuperscript{11} When it came to RBS’ recapitalisation, for instance, it was the UK taxpayer who was responsible, not the US taxpayer.

Firstly, it would have to import a sufficient quantity of sterling to ensure there was enough of the currency for people and businesses to use, and to allow the banking system to function. It could do this in two ways: running consistent current account surpluses; or borrowing heavily in that currency. Given that two of Scotland’s major exports (oil and gas) are in decline, the first of these methods seems an unlikely scenario for Scotland. The second is not a sustainable solution.

Furthermore, the lack of a lender of last resort could cause some severe problems for Scottish banks and as a consequence the entire financial system would become vulnerable, which may force them to relocate their headquarters to RUK\textsuperscript{13}.

In the article I referred to earlier, the First Minister noted that the Isle of Man is an example of a territory that uses sterling unilaterally and used this as an example to show that this option could be adopted by Scotland.

However, I do not believe this is a realistic comparison. Whereas the Isle of Man has a GDP of £3.8 billion\textsuperscript{14}, Scotland has a GDP of £150 billion\textsuperscript{15}. Moreover, its economy is far less complex than Scotland’s.

In my view sterlingisation would not be a realistic currency choice for an independent Scotland. Indeed, unilateral use of a foreign currency is an approach typically taken only by very small countries or territories, and is usually motivated by a counterfeiting of the existing currency, an exchange rate collapse, or a hyperinflation. Neither of these characteristics applies to Scotland.

**Joining the Euro**

While there is debate over whether an independent Scotland in the European Union would be legally obliged to adopt the euro as its currency\textsuperscript{16}, I will assume for simplicity that it is not a legal requirement.

Before it could join the euro Scotland must first meet the Maastricht criteria, which currently it does not. Whereas Maastricht requires countries to run a budget deficit of no more than 3% of GDP and a debt-to-GDP ratio of 60%\textsuperscript{17}, Scotland has a deficit of 5% and a debt-to-GDP ratio of 62% according to recent Scottish Government estimates\textsuperscript{18}.


\textsuperscript{16} See, for example, the written evidence of Dr Jo Murkens and Professor Robert Hazell to the Foreign Affairs Committee. http://www.publications.parliament.uk/pa/cm201213/cmhall/cmselect/cmfaff/643/643we13.htm. Last accessed 23rd January 2014.


Another criterion for joining the euro is to be a member of the exchange rate mechanism for at least 2 years, where the country's central bank is expected to maintain exchange rate fluctuations within a specified range. Clearly, Scotland does not have its own central bank, and nor does it have its own currency. So Scotland would either have to hope sterling could fulfil this role for them, or it would have to negotiate a special case with the EU.

It therefore seems unlikely that a separate Scotland would join the euro in the short term. If Scotland did adopt the euro eventually it would enjoy the advantage of having a lender of last resort, but its trade links with the UK would be damaged. I am also not convinced that monetary policy set by the European Central Bank would suit Scotland as well as current policy by the Bank of England, given that Scotland's GDP-weight in the euro-zone would be dwarfed by the larger countries such as France and Germany.

**A New, Separate Scottish Currency**

Scotland could of course introduce its own currency, an option favoured by many in the Yes Scotland campaign. I will refer to this as the Scottish pound (££).

With its own currency Scotland could choose to peg the ££ to any currency it wanted, which would most likely be sterling.

A ££/£ currency peg would bring more stability for businesses, but the Scottish central bank would effectively give up monetary policy as a policy instrument because it must increase the supply of ££ in line with its demand by buying and selling the currency on the foreign exchange market with its sterling reserves.

Alternatively Scotland could have a floating exchange rate, so the value of the ££ would be determined by supply and demand conditions prevailing in the foreign exchange market. Given that oil accounts for such a large proportion of the Scottish economy it should be expected that the ££ could experience significant volatility in the currency markets. Nevertheless, this option would give Scotland the most flexibility in responding to economic conditions.

However, a new currency would introduce substantial problems for Scotland. Apart from the significant transition costs of setting up a central bank some fundamental issues would need to be addressed. Firstly, if Scotland wanted to peg the ££ to sterling it would need to build up a large quantity of sterling reserves and maintain its discipline. The Scottish government would also need to be prepared for adjustments in the real exchange rate to occur largely through nominal wages and prices as it could not devalue its currency.

But even in a flexible exchange rate regime there would be important questions that would need answered. In what currency would Scotland's share of the UK's national debt be denominated in? What impact would the transition process have on the financial services industry and the economy as a whole? How would these issues be managed? How long would this whole process take? A separate Scottish currency would also most likely see the largest divergence between the Scottish and RUK economies, damaging current trade links with RUK. Businesses would also face
additional risks due to multiple transactions in different currencies. While this risk could be hedged it would only bring additional costs.

**Conclusion**

In my opinion retaining sterling would be the best option for an independent Scotland. However, I am not convinced of the case for RUK agreeing to this, and so I do not think the Scottish government should expect a deal to be reached without surrendering any assumed fiscal benefits of independence.

Politically this would be very hard to justify to the electorate. I therefore believe that in the likely event of failing to agree on a currency union with RUK an independent Scotland should introduce its own currency.

Against this backdrop I believe several questions remain for the Scottish government to answer:

- To what extent is the Scottish government willing to allow a foreign regulator to impose regulation on its financial system?
- If the RUK government insisted on significant oversight of Scottish fiscal policy would this be deemed acceptable by the Scottish government? At what point would oversight of the Scottish budget within a sterling-zone be too onerous?
- How does the Scottish Government anticipate future banking crises be managed? If there was a disagreement over the crisis resolution strategy, which government would have the final say?
- At present the Chancellor of the Exchequer is responsible for outlining the Bank of England’s mandate, such as its inflation target. If the Scottish government did not believe this mandate or any future mandate was optimal how would the disagreement be resolved?
- Likewise Bank of England support and unconventional measures such as quantitative easing must be authorised by the Chancellor of the Exchequer. If there was a disagreement on whether these policies were suitable, which jurisdiction would have the final say?
- If a currency union cannot be agreed which currency option does the Scottish government consider to be the most optimal?

In the same context, I also think the UK Government should clarify its position more clearly. Whilst I understand the case for not pre-negotiating Scotland’s independence, I believe the some general guidelines should be provided on the following issues:

- What steps would be taken if Scotland requested to retain sterling? For example, would there be a referendum in RUK on the issue?
- Is the UK Government open to the idea of a currency union? If so, what sort of fiscal and regulatory arrangements would they expect to be agreed upon? For instance, is the Maastricht criteria a model to follow or would further constraints be needed?