Dear Murdo,

INQUIRY INTO SCOTLAND’S ECONOMIC FUTURE POST 2014

At my appearance before your Committee, I committed to writing to you setting out my views on a Sterling currency union, including the transactions costs involved, if Scotland voted to become independent and adopted a different currency.

2. The Chancellor of the Exchequer and I took advice from Treasury civil servants, and on the basis of that advice, we said that we could not recommend that the other parts of the UK could share the pound with an independent Scotland in a formal currency union.

3. As set out in Scotland analysis: Assessment of a sterling currency union, the existing currency and monetary policy arrangements have served Scotland well. The United Kingdom is one of the most successful monetary, fiscal and political unions in history and has brought economic benefits to all parts of the UK.

4. Successful currency unions require political and fiscal integration which is an important source of stabilisation in times of economic difficulty. The United States is a highly successful currency union that is underpinned by fiscal and political union. Without the same mechanisms of mutual insurance, the euro
area has struggled to adjust to the effects of the financial crisis. In a sterling currency union, an independent Scottish state's interest rates and exchange rate would be common to the currency union as a whole. The public finances of an independent Scottish state would need to do more to support the Scottish economy. However, it is unlikely that an independent Scottish state would have the fiscal flexibility to offset large economic shocks, due to its fiscal position and the fiscal constraints imposed by a currency union and the financial markets. This is why I have said that a currency union would not be in the interests of either Scotland or the rest of the UK.

5. If you think that transaction costs are the only thing that matters, joining the euro or the US dollar would be equally attractive for a currency union. The dangers of a currency union are elsewhere. They are about the way in which risks are transmitted. This is the reason why the UK chose not to enter into a currency union with the euro area, despite a much higher level of trade between the UK and the euro area than between the rest of the UK and Scotland.

6. Alex Salmond and the Scottish Government have claimed that UK businesses would lose out from extra transaction costs if Scotland used a currency different to Sterling. The Scottish Government have claimed this would cost around £500 million for firms in the rest of the UK (0.03 per cent of UK GDP). It is interesting that the Scottish Government has drawn this estimate from the analysis that the Treasury did in 2003 of the five economic tests for joining the euro, but the Scottish Government ignores the rest of the analysis, which showed why joining that currency union would in many other ways be disadvantageous.

7. Using the same methodology as the Scottish Government, transactions costs for Scottish businesses would increase by £600 million if an independent Scotland used a different currency to the pound. This is equivalent to 0.4 per
cent of Scottish GDP in 2012. This is on top of the cost of creating an international border between an independent Scotland and the continuing UK. Borders matter: they reduce trade and labour migration, disrupt economic and cultural links, and lead to diverging regulatory and tax systems making it harder for businesses to trade. This is true even for countries with close cultural and historic ties, like the US and Canada. Treasury estimates that if Scotland were independent the reduction in trade would reduce incomes by 4 per cent. Put another way, household incomes in Scotland are £2000 a year higher because we are part of the UK.

8. Transactions costs and the border effect are some of the costs of independence. They are good reasons for keeping the UK together, not reasons for breaking it apart.

9. I look forward to appearing before your Committee again in June and wish you well with your inquiry. I am copying this letter to the Chancellor of the Exchequer and Secretary of State for Scotland.

Best wishes

DANNY ALEXANDER