Introduction
This submission is from John Nugée, Associate Fellow, Chatham House. The views expressed are however my own and not necessarily those of Chatham House.

The submission concerns Scotland’s choice of currency arrangements post 2014, and the consequences for the country’s capital markets and financial system. Since this is a live issue only if the referendum favours an independent Scotland, for otherwise there is no realistic alternative to the continuing use of sterling, the submission assumes that Scotland has voted for independence.1

Furthermore, for the purpose of the submission, it is assumed that Scotland has been unable to agree a formal monetary union with the rest of the UK (rUK). As set out in the paper “Scotland’s Future”, monetary union with rUK is the Scottish Government’s preferred solution to the question of Scotland’s currency; but as has been observed, such a solution depends on the consent of rUK, which may not be forthcoming.

The role of the financial system in the economy
In the years following the global financial crisis, a populist view has taken root that a large and active financial system is unnecessary, even undesirable, for a country. Not unnaturally in the light of recent events, there has been considerable focus on the costs of maintaining a large financial centre. But the economic evidence is clear that a strong, well-regulated financial system with active capital markets does benefit a country: as an enabler of financial activity for the wider economy, as a provider of highly skilled employment and as a guarantor of true economic autonomy.2

The contribution that Scotland’s current financial services industry makes to the Scottish economy is well understood. The country has built and maintained a strong presence particularly in the fund management, insurance and life assurance sectors. But, as part of the UK and the sterling area, activities by the authorities such as regulatory and central banking operations, together with sectors more sensitive to location or critical mass and scale effects such as capital markets, have naturally remained in London, and are consequently undeveloped in Scotland.3

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1 Other than the special case of the People’s Republic of China (PRC), where different currencies are used in the PRC itself, in Hong Kong and in Macao (and also in Taiwan, which the PRC considers part of its territory), there is no state in the world where there is more than one official currency, ie where two component parts of that state, however loosely federated, have separate official currencies. There are a very few states which have no official currency – Zimbabwe is perhaps the best known example – and in such circumstances multiple other currencies circulate and may even have de facto official approval, but such examples of failed economies are not relevant to Scotland’s situation.


3 Scotland’s highly developed banking industry, and the fact that substantial banks are head-quartered away from the UK’s financial capital, is slightly anomalous in a state as centralised as the UK has until recently been. It is possibly the result partly of history (the Bank of Scotland was founded before the Act of Union and the Royal Bank of Scotland only just after it) and partly of Scotland’s retention of its separate legal system, which meant that Scottish banks were not obvious targets for mergers with English banks when the English banking system consolidated in the 19th century.
Following a vote for independence, one question will therefore be how much of the “missing” parts of a financial system Scotland seeks to create, and how successful the country might be in doing so. The beliefs that underpin the remainder of this paper are firstly that there is no reason why Scotland should not seek to build as comprehensive a financial system as it can, and secondly that the choice of currency regime will have a major impact on how successful such efforts prove to be.

The three most commonly suggested currency arrangements for Scotland, should a monetary union with rUK not be possible, are “sterlingisation” (that is, the use of sterling without a formal monetary union with rUK), a separate currency pegged to sterling, and a separate freely floating currency. These, and their consequences for Scottish capital markets and the Scottish financial system, are now considered in turn.

**Sterlingisation**

In this scenario Scotland uses the pound sterling as its currency without either formal support from rUK or a formal role for the Bank of England. Historically, this was the solution adopted by the Irish Free State in the first years after its independence in 1922. The main consequence of sterlingisation for the infant Irish Free State was stability, and public confidence in the currency. In this sense the policy was a success, which was no mean achievement given the hyperinflations in Germany, Austria, Hungary, the Soviet Union and several other new or newly reformed European states in the 1920s. But a secondary consequence was that there was almost no incentive to create or develop separate capital markets in Dublin – no government bond market, no FX market, and the regional Irish stock market remained very undeveloped. There was not even a separate inter-bank market: the Irish banks all maintained large balances in London and used these to effect clearing between each other.

This pattern is also seen in other countries that use another state’s currency. Ignoring microstates, which would not expect to develop significant capital markets, several countries use the US dollar as their currency (e.g. Panama, Ecuador, El Salvador, East Timor) and a few the euro (Kosovo and Montenegro are the two best known), and in almost all cases the domestic capital markets are very limited or non-existent. The only significant exception to this rule is Panama, which has used the US dollar since 1904 and was able to develop a regional financial centre for the Caribbean and central America in the era before modern electronic communications when geographical distance mattered.

For Scotland, the most likely scenario, at least initially, would be similar. For the population, there would be the comfort of the familiar and little visible change: bank accounts would be unchanged and the circulating currency could remain as it is now – Scottish notes and sterling coins. There would be no reason for the population to change their savings and investment behaviour either: small scale investments would remain in Scottish retail savings accounts and under Scottish legislation but would still be in sterling, while larger sums would in all probability continue to be invested in the London capital markets.

Under sterlingisation, there must be significant doubt that Scotland would find it easy to establish active domestic capital markets – London is too close and communications too easy – and there must therefore be a risk that Scottish capital market financial activity

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4 Depending on the bilateral agreements made between the note-issuing banks and the Bank of England, the legal status of Scottish bank notes may change slightly, and they may resemble more the issues of the Channel Islands and Isle of Man – with the possibility that this will reduce their acceptability in rUK. But if so, this would be merely part of the greater distancing between rUK and Scotland that independence would entail in general.
would remain largely “offshore” (ie in rUK) and in the hands of foreign institutions for as long as sterlingisation held. The main consequence would be economic activity and tax revenue foregone, but there is also the danger that a future Scottish government might be tempted to employ “economic nationalism” – routing official business through local but smaller channels even if it is less economically efficient.

**Pegged currency**

With a separate Scottish currency that is formally pegged to sterling, Scotland would set up a central bank, together with an inter-bank money market to allow the central bank to carry out monetary operations. But whether private economic agents would support a full capital market must remain doubtful.

Indeed it is probable that impetus for the development of the financial system in Scotland would be heavily influenced by how secure economic agents considered the peg to be. This leads to a potential “catch-22” situation: if the population consider the peg to be secure, the greater draw of London will mean that there will be less pressure to set up domestic capital markets and the Scottish currency and its markets may well remain under-developed, while if the population have doubts about the Scottish currency and the peg, they may choose even more actively to keep their assets in sterling to avoid devaluation risk.

The Irish parallel is instructive here too. Having adopted a policy of sterlingisation almost by default, it was some years before the Irish felt it necessary to clarify whether the unit of currency in Ireland was legally separate from sterling or not. But even when Ireland had decided that their currency was legally a separate currency, the attractions and convenience of London’s markets continued to stunt the development of a Dublin-based money market and financial sector. For at least 25 years it proved hard to establish strong capital markets in Dublin when the Irish had access to the much more established ones in London.

This had other effects too. Since the Dublin government had one overriding policy objective in this field (ie, to maintain parity with sterling, not least because of the possible effects on national confidence otherwise), it was always tempting for them to overprioritise this single facet of economic management, even to the detriment of others, and to consider that if they were successful in maintaining the parity then they had “done a good job”, so nothing else needed to be considered. Indeed one might characterise Irish economic management in the 30 years following independence as unimaginative and risk-averse, even complacent. And without an active central bank or liquid domestic capital markets, the tools available to Irish banking were extremely basic until well after the Second World War, and most economists consider that this had a knock-on deleterious effect on the country’s general economic development and progress, to the extent that by the 1950s Ireland’s economy was among the weakest of all of Europe’s then democracies.

Other examples again support this analysis. There are a number of countries with pegged currencies (that is, legally separate units but at a fixed parity to and largely interchangeable with a bigger unit): much of the Caribbean is pegged to the dollar, Lithuania, Bulgaria and Bosnia peg to the euro, several countries in southern Africa peg

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5 There is always the possibility that the Scottish currency would revalue upwards on any break in the peg, but in practice governments are much more able to maintain a peg that is under upward pressure than they are to maintain a parity which is under downward pressure.

6 The Irish government created a Banking Commission to consider these issues, but it did not issue its first report until 1926, 4 years after independence, and it was not until 1928 that the decision was made that the currency of Ireland should be the Irish Pound, pegged 1-1 to sterling.
to the Rand, the Australian and New Zealand dollars are used widely in the Pacific islands and Brunei pegs to the Singaporean dollar. In almost every case – and interestingly, whether the peg is at parity (ie 1-1) or some other exchange rate – domestic markets in the smaller currency remain undeveloped.

The only significant exception to the general rule that countries with pegged currencies tend to have underdeveloped financial systems is Hong Kong. But Hong Kong is not typical of such arrangements: it had had a separate currency and independent financial system for a long time prior to the introduction of its current linked exchange rate system, and only linked its currency to the US dollar in 1983 (and then only loosely; it is not an exact fixed peg) to combat turbulence resulting from the specific uncertainties of its then imminent transition from British to Chinese sovereignty.

The parallel with the position in Ireland and other countries is not exact, but there must be significant doubt that Scotland would find it much easier to establish active and liquid domestic capital markets under a competent and trusted pegged regime than it would under sterlingisation.

**Floating currency**
Here the challenges are different. With a separate and floating currency, there would be a clear need for domestic capital markets, not least to enable the government to issue debt and the new Scottish central bank to conduct monetary and FX policy. We can assume that separate markets in the new currency would quickly be established and functional.

The challenge is rather to ensure that economic agents – ranging from institutional investors to retail savers – have confidence in the new currency and markets. There is a virtuous circle in which markets are established, investors repatriate their funds (whether out of nationalistic fervour or simply to match assets to domestic liabilities on risk management grounds), issuers wish to tap into the new pool of Scottish capital, the markets flourish and confidence is quick to take root and grow. But the alternative scenario is one where investors are uncertain and keep their money in London, the markets falter and the circle is much less virtuous.

Precedent is much less of a guide here. There have been many European countries that have won their independence in the 25 years since the fall of communism and the break-ups of the Soviet Union, Yugoslavia and Czechoslovakia, and before that there was for example the dissolution of Austria-Hungary after the First World War. In almost every case, the new states established new currencies. But in general the currency they left behind was unattractive or failing, and the new currency was secured behind exchange controls that compelled citizens of the new state to accept it. There is almost no precedent in recent history for a population voluntarily to leave a currency which is successful and internationalised and to invest a significant proportion of their financial assets into a new currency that is untried.

**Conclusion**
This submission has looked at the narrow question of the impact of Scotland’s choice of currency on the formation of domestic capital markets and financial activity. The conclusion is that establishing new capital markets and winning public acceptance for them is by no means a trivial task, and the closer Scotland cleaves to sterling, the more difficult this may prove to be.

John Nugée, April 2014