SCOTLAND'S ECONOMIC FUTURE POST-2014

SUBMISSION FROM PROFESSOR ANTON MUSCATELLI

Introduction

I thank the Committee for the invitation to appear in connection with this inquiry. I would like to point out at the outset that I am appearing in a personal capacity, as a Professor of Economics. As the Committee will be aware I am also Principal of the University of Glasgow. As an educational and charitable institution, the University of Glasgow takes a neutral position on the independence referendum. As the head of that institution, it would therefore not be appropriate for me to take a position on the constitutional question per se. I will therefore not address the issue of whether Scotland should be independent, but restrict my comments to technical economic advice and what might be the best policy options if there was a 'Yes' vote in September 2014.

In my written evidence I will focus on Scotland's choices in relation to macroeconomic policy and the choice of currency following independence. As an economist I am able to offer my views on the most appropriate choices should Scotland vote for independence in September 2014, and how it should best shape its economic institutions. I can also offer a perspective of what, in my view, might be the best choices for the rest of the UK (rUK), in such an event.

I shall focus in turn on the optimal choice of currency in the event of independence for Scotland and rUK; on the fiscal and monetary policy arrangements which would underpin that choice; and on longer-term choices and options facing Scotland following independence.

The choice of currency for an independent Scotland and rUK

A variety of different and contrasting views has emerged on the currency options for Scotland and rUK, ranging from the Fiscal Commission Working Group (FCWG) (2013); to HM Treasury's analysis (2013, 2014), supplemented by the publication of a letter of advice to the Chancellor of the Exchequer by the Permanent Secretary, Sir Nick Macpherson; to contributions from Armstrong and Ebell (2013, 2014) and MacDonald (2013), to cite but a few publications. At the same time, there has been an analysis of currency unions in the speech by the Governor of the Bank of England (Carney, 2014), which does not express a view on the preferred options for Scotland and rUK, but considers the advantages and disadvantages of currency unions, and how they might best operate.

At the outset, let me say that I endorse the view, expressed by the Scottish Government, following the recommendations of the FCWG, that maintaining a sterling currency union between Scotland and the rUK would be advantageous to both countries after independence. Let me outline why I believe this is the case.

The starting point for my analysis is that Scotland and rUK would begin in September 2014 from a position of being a single integrated market, with a high degree of labour and capital mobility, and highly integrated supply chains across many sectors. The starting position which these two countries will find themselves in would be very different from that of any two countries in other monetary unions (e.g. EMU).

As a result, transactions costs are likely to have a significant negative impact on both Scotland and the rUK economies if the Sterling currency area is abandoned. In assessing the benefits in terms of lower transactions costs, the usual reference point is the introduction of the Euro, with an estimate of 0.1-0.2% of GDP (European Commission, 1990), although some other reports (HM Treasury, 2003, Carney, 2014) suggest the gains in terms of lower transactions costs for open economies exporting to the Eurozone might be of the order of 0.5%-1% of GDP. The benefits to Scotland of a currency union are clear, given that around two thirds of Scottish exports are currently to rUK. A more interesting issue is what benefits rUK businesses derive from maintaining a Sterling union with Scotland. One potential way of estimating rUK benefits is to look at the share of UK-EU trade flows to Scotland, and to impute transactions costs by taking the 0.1-1% ‘Euro’ range of transactions costs estimates in relation to UK GDP. Exports from rUK to Scotland are around 40% of UK exports to the EU and 23% of UK imports from the EU (Scottish Government, 2013). This would produce estimates of lower transactions costs for rUK businesses of around £500m from sharing Sterling as a currency if one takes the 0.1% low estimate. This would scale up to £1bn for the 0.2% estimate, and even £2.5bn+ for the higher cases cited above.

Clearly these calculations can only be approximations, but it is important to stress that there are other benefits to rUK of maintaining Sterling, which are less easy to quantify. For instance the UK imports £13.6 billion of oil and gas from Scotland which would also be hit by transactions costs. In addition, not all exchange rate risks can be hedged, and there is no doubt that breaking up the Sterling monetary union would create additional barriers to cross-border investment by rUK and Scottish firms.

Another perspective on the trade gains from having a currency union comes from so-called ‘gravity models’. These models try to estimate the effects a currency union has by reducing trade costs and hence increasing (or maintaining) trade flows. Initial work by Rose (2000) and Frankel and Rose (2005) estimated that currency unions could triple bilateral trade between union members. These initial estimates were criticized by Baldwin (2006) and others on statistical grounds and for ignoring multilateral trade effects. Although some studies show that the adoption of the Euro had a negligible effect on deepening trade ties (Santos Silva and Tenreyro, 2010), a number of other studies still detect very strong effects, after allowing for other variables. For instance Eicher and Henn (2011) find that for the Eurozone the common currency had a 40% increase on trade flows, all other things remaining equal.

Given these costs, why might rUK choose not to enter a currency union? Focusing solely on economic rather than political considerations, the arguments against currency union tend to fall into the following categories: first, problems in adjustment to macroeconomics shocks, usually focusing on Scotland’s greater dependence on oil and gas production following independence (MacDonald, 2013, HM Treasury, 2014); second, potential difficulties which might be caused by future financial crises, focusing on Scotland’s dependence on the banking and finance sector and the asymmetry of a Sterling monetary union (HM Treasury 2014); and, third, the management of a currency union in situations where debt to GDP levels are high (Armstrong and Ebell, 2014). I will consider these in turn.

First, the FCWG suggests that Scotland and rUK are an optimum currency area because of the integrated nature of the two economies, and the high degree of labour and capital mobility. One counterargument (HM Treasury, 2014, MacDonald, 2013) is that if 90% of the oil and gas reserves of the UK are assigned to an independent Scotland, then this might make the Sterling union subject to asymmetric shocks, and that these would be worse in the absence of a nominal exchange rate. In other words, the argument is that following, say, an increase in the oil price (which would benefit Scotland and not rUK), or indeed any other economic shock affecting one country but not the other, being forced into a single currency would deprive both countries of a useful adjustment mechanism. HM Treasury (2014) shows a number of simulations using a ‘4-blocs’ macroeconomic model (the ‘4 blocs’ being Scotland, rUK, the Euro-area, and rest-of-the-world). Using this they show that Scotland might benefit from having its own currency as an instrument to stabilise the economy in the face of shocks. In essence this draws on the perceived problems with European Monetary Union: it is argued that EMU has been found wanting because a currency union only works when combined with a fiscal union (and hence a political union).

However, there is a fallacy in this argument, and the comparison with EMU is inaccurate. There have been serious issues of adjustment within the Eurozone, but that is because a currency union was introduced in Europe where ‘border effects’ were still very significant, and the integration of goods, capital and labour markets and regulatory frameworks was incomplete. In addition, the stability and growth pact was flawed both in design and implementation. In contrast, the Sterling union between Scotland and rUK already exists, the two economies clearly constitute an optimum currency area, and whilst ‘border effects’ might eventually emerge as the two economies evolve differently, this will not happen overnight. A comparison with EMU is spurious because trade flows and labour mobility between rUK and Scotland are not the same as those between, say, France and Germany, or Germany and Italy.

Of course there were some design flaws in EMU, and these would need to be corrected in a Sterling zone. The FCWG stresses that there would be a need for fiscal rules which rUK and Scotland’s governments would need to adhere to. There would need to be a rule to ensure that (cyclically-adjusted) budget deficits kept within limits, and another to ensure that the debt-GDP ratio for each country remained on a sustainable path. Two other elements would need to be put in place: first, the deficit rule would need to be made symmetric (unlike the defective 3% deficit rule in the Eurozone stability and growth pact, see Muscatelli et al. 2012) to ensure that both governments run surpluses during economic upswings; and second, there would need to be some form of enforcement on both governments to ensure adherence to the fiscal pact. These sanctions were suggested, but never enforced in the Eurozone (Muscatelli et al., 2012). With only two parties in the Sterling union, enforcement should be much more straightforward than in the Eurozone with its complex governance structure. However, even with a fiscal and debt rule, the rUK and Scottish government would have considerable freedom to pursue very different spending and taxation policies. What matters for the stability of the currency union is the overall fiscal stance of the two countries.

There is another interesting way in which a Scotland-rUK currency union on day 1 would differ from EMU. The two countries start with a mutualised debt position: a stock of mutual debt which the two governments could agree to service on a negotiated basis. This is unlike EMU where this idea of shared debt (e.g. Eurobonds) to underpin the monetary union has not been realised. Immediately after independence rUK have already confirmed that they will hold the legal title to the debt (which has a long average maturity by OECD standards), and Scotland would issue its own debt as it has to borrow to service its share of it. Any risk spread on borrowing rates would apply only to the new debt issued.

Turning to the simulations within HM Treasury (2014), one difficulty with these simulations is the absence of any dynamic supply effects. The model is a static aggregate demand and supply model, which in essence assumes that the only aspect of the economy which will change after independence is Scotland's exposure to oil prices. Interestingly Carney (2014) points out that currency unions can be made up of dissimilar as well as similar economies. But of course other things might change after independence: a smaller open economy like Scotland might well develop its taxation system, its collective bargaining structures and its labour market and welfare policies to allow for more flexible price and wage adjustment. This would radically change the simulations in HM Treasury (2014). This is actually a key point: a useful future exercise for the FCWG would be to consider how Scotland might be able to deploy active fiscal and supply side policies to offset temporary shocks. Indeed, the FCWG has already, through the recommendation of the establishment of Stabilisation and Savings Funds for Scotland, addressed one aspect of this. Again, there is a general recognition that most small open economies tend to run more prudent fiscal and net asset positions than larger economies (although the pattern is not always uniform across the OECD). The pattern of government spending also tends to vary between small open economies and larger economies.

Another reason why it is suggested that rUK might not enter a monetary union with Scotland is the relative size of the two economies, which given the size of the banking sector in Scotland is problematic (HM Treasury, 2014). It is argued that, as rUK could bail out Scotland but not vice-versa, then this would introduce an asymmetry into the relationship which would prevent rUK from joining. There are three responses to this. First, it is difficult to estimate the percentage of UK Financial Services which should be allocated to Scotland, and indeed it may not remain the same after independence. It is arguable that UK banking assets as a percentage of UK GDP might not be that different from 'Scottish banking assets' as a percentage of Scotland's GDP. HM Treasury (2013) comes to a very different estimate to that obtained by Scottish Government. I also think it likely that the economic footprint of the industry will change over time, particularly given the focus of London as a financial centre. Second, the asymmetry problem identified by HM Treasury (2014) is only an issue if there is an assumption that Scotland's banks are more likely to face a financial crisis in future than those in the rUK. This is unlikely. The 2007-09 crisis was one which affected many Western economies, and which required a co-ordinated response in any case. Overall, I would agree with Carney (2014) that for both Scotland and rUK the real problem here is the existence of banks that are 'too big to fail', and that has to be addressed regardless of the currency regime. The problem here is about regulation and reform, not the Sterling currency union per se. Reforms such as that proposed by the Banking Reform bill should address these issues. Finally, if the incentives and risks are perceived to be asymmetric between rUK and Scotland, then as part of a negotiation for a currency union, this asymmetric risk could be priced into the fiscal rules for the two countries. Indeed, as the larger partner, rUK could minimise the risk to their economy through a formal monetary union and negotiate a set of institutional arrangements to deal with potential risks.

Turning to the issue of managing a currency union in the presence of high levels of debt, some observers (Armstrong and Ebell, 2013) have suggested that this is a problem for Scotland, and consider some simulations to show that Scotland would need to run sizeable budget surpluses to bring its debt-GDP ratio back to 60%. It's not clear why this is the focus of the simulations given that, post-crisis, few Western economies are likely to be able to return to such levels of debt in the short term. Clearly high levels of debt raise issues of sustainability, which have to be managed as part of the fiscal rules in a currency union (Belgium in the Eurozone is a case in point). But most estimates I have seen of debt-GDP ratios for rUK and Scotland do not suggest that they will be of a different order of magnitude after independence on most scenarios for dividing up the UK's assets and debt.

Alternatives to a Sterling currency union

Ultimately whether rUK and Scotland will join a currency union is a political decision. Although it may be in the economic interest of both countries to join, neither country can be forced to do so against its will. In addition, the issue of currency union is logically separate from the issue of how one should divide up the assets and debts of the UK and its institutions, including the Bank of England.

What would Scotland's optimal choice of currency regime be if rUK refuses to join a currency union? The FCWG considers all the other options. Of these, it seems unlikely that Scotland would wish to join the Eurozone, as the FCWG recognizes. The Eurozone is still evolving, has faced serious adjustment problems, has a flawed governance structure around monetary and fiscal policy, and as noted above there are real doubts as to whether it operates as anything approximating an optimum currency area. In any case entry to the Eurozone is tied to issues around EU accession.

It has been suggested that Scotland could adopt Sterling unilaterally if rUK refuses to join a currency union. I would not recommend that option. Dollarisation has been observed in small economies like Panama, or Euroization in Montenegro. But arguably the unilateral adoption of another country's currency is a high risk strategy for an advanced and modern industrial economy. Scotland would have no control over its money supply, and as the FCWG points out Scotland would have no access to a lender of last resort facility from the Bank of England, which could subject its banking sector to liquidity crises. It would be a potentially unstable currency regime where external shocks could not be offset through monetary policy.

Sterlingisation would also not be desirable for rUK. Unlike Panama and other Dollarised economies, Scotland's money supply would make up a substantial proportion of the UK's money stock (about 10%), and having such a large proportion of its money supply being used informally would not be without macroeconomic risks for rUK.

A much preferable 'plan B' would be for Scotland to adopt its own currency. It would have a choice at that point as to whether to shadow the pound in a similar way that

Denmark chooses to do against the Euro, or whether to establish an alternative macroeconomic framework, and allow its exchange rate to float more freely against the pound, the Euro and other currencies through a managed float such as Sweden. The merits of each would depend on a number of factors. Scotland (and rUK) would lose from such an arrangement in terms of transactions costs, but would gain in terms of having monetary independence. In the longer term Scotland could manage the transition to its own currency as the Scotland and rUK economies develop structurally and might diverge over time and a 'border effect' becomes evident in trade flows. There is no doubt that Scotland could launch a successful currency, and this would be the most obvious 'plan B' if a Sterling union cannot be negotiated. Even if a currency union can be successfully negotiated, it would be in Scotland's interest to consider its longer term options by building the necessary institutions to have its own monetary policy.

Conclusion

This evidence has considered different perspectives of the choice of currency union as part of the macroeconomic framework for rUK and Scotland following a vote for independence in 2014. My view is that a Sterling currency union has benefits which clearly outweigh the costs for both Scotland and rUK. There are costs and benefits from any monetary union, and different commentators (FCWG (2013), HM Treasury (2014) and Carney (2014)) have highlighted different aspects of these. The key to a successful monetary union is that the policy framework and institutional arrangements should be well designed. Those who argue against a Sterling currency union point to EMU as a system where the costs are seen as outweighing the benefits. My central view is that the opposite is the case for Scotland-rUK, mainly because the starting point for the sterling currency union is a very different one from the Eurozone. Scotland and rUK would begin from a position of two highly integrated economies, in terms of their goods and labour markets, and their regulatory frameworks. It is also worth considering that the alternatives to a monetary union carry costs, not just for Scotland, but also for the rUK.

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March 2014