In my evidence to the Economy Energy and Tourism Committee I am going to focus on the choice of an appropriate currency regime for an independent Scotland, for two reasons. First, and in terms of the economics of the independence debate, the currency issue has clearly become the dominating theme, presumably since it plays such a central role in effecting a country’s competitiveness, and the interest rate and exchange rate policies it may pursue. Secondly, currency and monetary regime issues are of particular interest to me and are my main speciality in the area of monetary policy, the theme being discussed by the committee.

Central to the recent discussion of a currency regime for an independent Scotland is the proposition by the Scottish Government that the most appropriate regime for an independent Scotland is a formal sterling monetary union. The main purpose of my evidence is to show that far from being the best option for an independent Scotland sticking with sterling, in whatever form, would be a very heavy millstone indeed around an independent Scotland’s neck, and would have significant and real implications for its non-oil sector, including the financial services sector.

In addressing why a sterling zone is such a bad option it is instructive to look at the case made by the Fiscal Commission (FC) appointed by the Scottish Government. As has been widely noted, they looked at a variety of options for an independent Scotland, including membership of the euro, an informal sterling zone and an independent currency and concluded in favour of a formal sterling monetary union. In this regard, the key criteria considered by the FC are: trade between members of a proposed currency area compared to trade with countries outside the proposed currency area; capital and labour mobility; productivity; alignment of economic cycles. On the basis of these criteria the FC judged that maintenance of the UK currency zone to be the best currency option.

For example, on the criterion of productivity the FC note that Scotland’s productivity is convergent with that in the rest of the UK (rUK): ‘…the latest data for 2011 has Scottish productivity at either 97% or 99% of the UK average.’ However, the ‘criteria approach’ used by the FC to assess the suitability of a sterling zone is very dated and methods have moved on to looking at the kind of shocks hitting a country – are they supply side or demand side, are they asymmetric or symmetric and if the latter could they have an asymmetric effect? This may seem a rather arcane distinction but it matters crucially in the debate about the appropriate currency regime for an independent Scotland. Why?

The crucial item that is missing from the FC’s analysis of the appropriate currency regime for an independent Scotland is that an independent Scotland would become a net exporter of hydrocarbons. Oil price shocks are regarded as supply side shocks and in the context of a sterling zone regime they would be regarded as asymmetric shocks (simply because rUK would not be a net exporter of hydrocarbons). Furthermore, the Scottish Government has given an undertaking to improve
Scotland’s productivity relative to the rest of the UK which would represent another supply side shock and an asymmetric one to boot if rUK productivity remained unchanged. A key element in the recent literature on monetary unions is that two countries that exhibit asymmetric supply side shocks should not form a monetary union and this is much more than a theoretical argument.

For example, the Nobel laureate, Professor Robert Lucas, pointed out that a supply side shocks impart considerable volatility - that is uncertainty - into a country’s real exchange rate; that is, a measure of a country’s competitiveness (essentially its price movement relative to its trading partner(s) price movement). It may seem odd to think of prices changing between countries in a monetary union but as the euro zone experience shows inflation rates can differ between countries especially with productivity differences. The extra kick to competitiveness from oil is likely to be profound, and large, which is of course is why no net exporter of hydrocarbons has joined the euro zone and indeed no net exporter of hydrocarbons with an important non-oil sector is currently in a monetary union or wants to join a monetary union with non-hydrocarbon exporting countries.

It is therefore clear that the analyses the Scottish Government has used to reach the conclusion that a Sterling monetary union is its preferred option is very seriously flawed: it relies on taking Scotland today as economically convergent with the rest of the UK, rather than a post independent Scotland which would be economically divergent. But what would be the consequences of an independent Scotland joining such a flawed union? The key to understanding this is to recognise that Scotland already has a well-diversified non-oil traded sector with a plethora of exports ranging from financial services to computers and buses. Changes in competitiveness and volatility in competitiveness, brought about by the inevitable oil price shocks, would be unwelcome, especially for companies trading in the rest of the UK as it would create uncertainty in their trade with rUK. This would inevitably lead to them moving at the very least their share of trade with the rest of the UK south of the border, with the direct and indirect implications this would have for jobs and also the tax revenues available to a Scottish treasury.

In addition to the above problems with the sterling zone proposal, the Scottish Government has a severe credibility deficit with respect to its pronouncements on its preferred currency regime. For example, the key insight of two Nobel Laureates, Professors Finn Kydland and Edward Prescott, that governments have to be ‘time consistent’ in their policy pronouncements is now embedded into the textbook macroeconomic genre. In layman’s terms what this means is that if a government makes a pronouncement about a policy issue – its commitment to low inflation, say – it must mean it and make credible statements over time in this regard.

However, although the Scottish government states that it will only countenance a sterling zone arrangement for an independent Scotland, elsewhere it has stated: “The Scottish Government is clear that post-independence it will always be up to the people of Scotland, and their elected government, to decide what our currency should be”. This is clearly time inconsistent and non-credible, since it makes clear that the sterling zone is not irrevocable, and therefore renders any attempt to form a sterling currency area futile and redundant because financial markets will not believe it to be a credible arrangement.
The alternatives to forming a sterling zone with rUK are now well rehearsed. The option of adopting the pound anyway (so-called sterlingisation) can be ruled out as a runner pretty quickly. It would suffer from the same supply side shocks as noted above and there would be no means of controlling the effects of competitive shifts on the non-oil traded sector. There would also be no central bank to provide day-to-day liquidity in the money markets as the demand for money changed and act as a lender of last resort in times of crisis. In essence sterlingisation would give Scotland the economic status of a failed state.

Pegging the currency to sterling on a parity (one to one) basis is another widely discussed option. This would in all likelihood have to be set as a currency board arrangement along the lines of the Hong Kong currency board. However such a mechanism is set up, it is a form of fixed exchange rate regime. To run and defend a fixed exchange rate regime against speculation you need very significant foreign exchange that a newly independent Scotland would simply not have. But even if such a peg was possible to establish and defend it would suffer from the same kind of deficiencies as sterlingisation.

Joining the euro-zone would raise the same type of issues relating to trading competitiveness that would arise in a sterling currency union, as discussed above. Furthermore, an independent Scotland would be unlikely to meet the relevant criteria for membership, which are likely to become even stricter in the future.

This then leaves a separate currency as the only viable economic option for an independent Scotland. As we have noted, an independent Scotland is unlikely to have sufficient foreign exchange rates to run a managed exchange rate regime and so the exchange rate of an independent Scotland would initially have to be freely floating; that is determined by the intersection of demand and supply on currency markets. A key feature of floating exchange rates is that they tend to be volatile and such volatility can impart substantial exchange rate risk into the economic environment with the consequent knock on effects this has for trade and investment.

An independent Scottish Government that has no track record in raising the revenues to pay for its expenditure would need in the post independence transition period to run fiscal surpluses to create the required credibility in international capital markets. In other words, the government of an independent Scotland would need to run an austerity programme with all of the implications this would have for taxation and public spending. However, once the Scottish Government’s reputational credibility had been established in international markets it would then be able to design an optimal exchange rate policy – one designed for both its oil and non-oil sectors – although as the Norwegian experience shows that is not a straightforward matter. But how long would this transition be and would it in fact be sustainable or would it break down with all of the uncertainty that this would impart into currency movements?

The inescapable logic of a study of the appropriate currency for an independent Scotland is that it would have to have its own currency. If Scotland wants to stay part of a formal sterling zone then it clearly needs to internalise its supply side shocks with the rest of the UK and that can only happen in the political and monetary union we have at the moment. The only credible alternative that an independent Scotland
faces is to have its own currency. So the currency choice is binary: if the people of Scotland want to be part of the sterling zone they have to be part of a political union with the rUK. Political independence requires an independent currency. Doubtless in the longer term this would work out. But the transition to this is uncertain and fraught with economic difficulties and uncertainties and as John Maynard Keynes noted: in the long run we are all dead anyway.

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