One of the important elements in managing expectations and creating the foundations for informed debate about the nature of Scotland’s economic future after the Referendum is to clarify what is meant by ‘independence’. In a globalised economy, the range of truly independent macroeconomic policy choices is constrained. This is obviously true in the Eurozone, but it also pertains more widely. The UK itself cannot pursue the full range of expansionist fiscal and monetary policies because this would lead to a significant depreciation of the pound, with damaging consequences to the cost of imported goods and ultimately the cost of living. Japan and the USA come the closest at the moment to pursuing independent economic policies, but this has had destabilising effects on the international monetary system. Governments (other than the USA) are also constrained by international capital markets when they rely on borrowing. There is no true ‘independence’ or full ‘sovereignty’ in a globalised economy. What is being asked in the Referendum is whether Scotland should be constitutionally independent.

**Monetary affairs**

The discussion around monetary affairs assumes the Mundell-Fleming Trilemma will apply to the Scottish case as a small open economy. In essence the Trilemma asserts that only two out of three options are sustainable: fixed exchange rates, monetary policy sovereignty, free capital flows. The diagram below sets out this framework.

![Policy Trilemma](image-url)
Historically, nation-states have sought to prioritise national monetary policy sovereignty and this led to a vacillation in policy between pegged or fixed exchange rate regimes with capital controls (e.g. 1945-73) or open capital markets and (more or less) floating exchange rates (1985-2013). But these solutions were not completely consistent or coherent. Many states have periodically imposed exchange controls (e.g. Malaysia, Brazil, Chile) to moderate exchange rate volatility. The biggest exception, of course, is China where tight capital controls protect monetary policy sovereignty with a managed exchange rate. Moreover, Rogoff and Reinhart have shown that there is a significant difference between which exchange rate policy is claimed by the government, and what it operates in practice.¹ There are very few genuine freely floating regimes where the exchange rate is ignored.

Even within this stylized view of the dimensions of policy options, the historical record shows that there can be some room for maneuver in the short term, and that the ‘short term’ can last for up to a year.² The amount of flexibility that can be achieved in fiscal and monetary policy depends on the credibility that the rate will ultimately return to the par value.

Recent research is also suggesting that imposing capital controls to protect against distorting influences in a global business cycle may be a good way to protect monetary independence.³ The new emphasis on macro-prudential approaches to achieving financial stability also suggests that governments may be constrained in their choice of domestic economic levers by fluctuations in global financial markets even when exchange rates are flexible. In sum, the Trilemma was developed in the 1960s when the share of global finance in global GDP was much smaller than today and it may no longer be an appropriate representation of policy options.

Currency

In the short term the best option for a constitutionally independent Scotland is to continue in the current sterling area. Scotland already operates a distinctive paper currency backed by reserves at the Bank of England; a quasi ‘currency board lite’. But in the longer term it may be appropriate to develop a currency backed by assets held nationally and managed nationally.

Strains in the Eurozone since 2010 have highlighted the difficulties of operating a monetary union across a range of sovereign states in a region with economies at different stages of development and per capita income. This is NOT the case for Scotland and the RUK where per capita income and the structure of the economies is relatively similar. However, the Euro crisis has highlighted that inconsistent fiscal policy will affect the integrity of a currency union in damaging ways.

The question of fiscal institutions is an important one. Institutions are a set of agreed rules governing behavior; a monetary union would require an agreed set of rules for borrowing and the fiscal deficit as a share of GDP for each partner in the union. The UK gross debt as a share of GDP doubled from 2007 to 2012 to 88.7%\(^4\), which is slightly higher than the EU average (newer member states in Eastern Europe have much lower gross debt than older members of the EU). The determination of the fiscal rule will need to be carefully managed to ensure that it ensures the RUK contracts the gross debt. The NIESR suggests that after constitutional independence, Scotland’s debt/GDP ratio will be lower than that of RUK.\(^5\) Within this fiscal envelope there would be room to develop different structures for the distribution of spending and tax.

Examples of previous currency disintegration are not very numerous. Historical examples include the Scandinavian currency union of 1901-5 (which foundered on political dissolution between Norway and Sweden) and the joint colonial currency boards in East Africa, West Africa and West Indies. Ghana and Nigeria in West Africa launched central banks at independence in the late 1950s and the East African Currency Board fell apart in 1966, soon after the constitutional independence of the constituent states because of divergent inflationary policies. More recent examples include the collapse of the Soviet Union and the creation of new states in eastern Europe during the 1990s, the division of Yugoslavia into Slovenia and Croatia in 1991, the peaceful separation of the Czech and Slovak republics in 1992. Dissolving a monetary union is an expensive process for both partners; they risk of losing confidence due to uncertainty and bear direct costs of replacing existing note issue etc. (although there may be gains from seignorage). As a result, gradual drift away from trade intensity or diverging inflation preferences have not prompted many monetary dissolutions, as the Eurozone crisis demonstrates. Instead, political change has usually been the catalyst for disintegration as new states seek policy independence and the presentational advantages of a separate currency as part of nation-building. In the case of Scotland, there seems no reason to presume that the over-arching macroeconomic goals of an independent Scottish government will inevitably diverge sharply in the short term from the targets of growth, price stability and low unemployment, which is the current framework.

The HM Treasury Scotland Analysis examines the case of Ireland, which maintained a firm currency peg to sterling for over 50 years after constitutional independence was achieved. Sterling’s instability and the relatively poor performance of the British economy in the mid-1970s prompted the Irish government to consider alternatives and the potential to link to the more successful economies in the core of Europe offered an opportunity to make this break in 1978. Similarly, Scotland may find in time that the RUK economic performance and currency stability may increase risks to financial stability which will prompt a reconsideration of the monetary union with the pound.

A main lesson of previous examples is not to be hasty. Consider the monetary disintegration of Malaysia and Singapore, which had shared a currency for 100 years

\(^4\) Eurostat data

\(^5\) http://niesr.ac.uk/blog/scottish-independence-and-uks-debt-burden#.UuuHsrQxjAk
before abrupt political separation in 1965. At first the Central Bank of Malaysia offered to issue currency and operate monetary policy for both states. The IMF was called in to advise Singapore and emphasized the importance of cooperation and coordination of fiscal and monetary targets. A statute was drafted to establish a branch of the Central Bank of Malaysia in Singapore which would issue distinctive notes (the Scottish example was cited) and these currencies would circulate at par in each country. In the end, disagreement about the distribution and location of the central bank’s assets became the obstacle that blocked a federal central bank system. Instead, a monetary union was introduced in 1967; Singapore operated a currency board and Malaysia had a central bank and the notes of both were ‘customary tender’ in each country. This system persisted for six years of rapid economic growth in both states despite political hostility between the two states. Ultimately, however, Singapore preferred a rules based system of policy-making to promote sustainable economic growth while the Malaysian government sought a more discretionary policy framework to support expansionary development policies. Malaysia suspended inter-changeability in 1973, but the currencies remained fully convertible and both partners ensured exchange rate stability supported their national economic interests in an integrated economy. The process of monetary disintegration through this staged process avoided a currency crisis or financial instability while promoting economic growth and development at a volatile time in the international monetary system.

There are clear issues when trying to deploy lessons from the 1970s or even the 1990s. The first is the innovation of the Euro and the European Central Bank. During its initial decade European monetary union appeared to operate successfully, but failures of governance and compliance to the fiscal institutions led it to the brink of failure in 2010-11. The strong collective commitment to the single currency has overcome these challenges for the moment and the renewed commitment to the future development of the ECB exhibited in the Single Supervisory Authority may make the structure more robust.

A second important development is the growth in global financial markets. Bonds, equities and bank assets are now 372% of global GDP. The ratio is even higher in the EU (530%) and the UK (804%). This size of global financial markets affects the degree of policy independence that can be achieved under any regime, other than one that restricts capital markets.

A final important consideration is the global spread of independent central banking, and in particular the innovations since the 1990s that are designed to ensure the independence of the Bank of England from government. This changes the political context within which monetary policy is determined.

**In the event of a No vote**
Scotland’s future economic policy will need to respond to changes in the European and global context as well as the relations with the RUK in the years immediately following the Referendum whatever the outcome.

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Greater powers of local taxation and spending could support distinctive borrowing on the international capital markets in the same ways as the provinces of Canada or the states of the USA. The Provinces of Alberta, British Columbia and Saskatchewan all have AAA rating but do not have central banks. Together, these initiatives could deliver space to introduce greater reforms to the structure of the Scottish economy within the UK.

A critical issue will be to plan for the contingency that a UK Referendum results in withdrawal from the EU. Some diversification of exports from EU to the rest of the world has taken place in recent years, according to the Global Connections Survey. This will require ensuring both that Scotland’s links with EU countries are strengthened and also leveraging the potential of expanding other markets. It will be critical that Scotland’s voice is heard strongly in the run-up to such a referendum (in RUK and in Brussels) and that Scotland’s interests are distinctively represented in any prior or subsequent reorganization of the relationship between the EU and the UK.

The views presented here are of the author in a personal capacity and do not reflect the views of the University of Glasgow.

Professor Catherine Schenk
January 2014