I should like to talk about an aspect of independence that seems to have received little attention, namely the economic benefits to England, Wales and Northern Ireland that would flow from Scotland continuing to use the pound sterling after independence.

Economic activity among trading partners in a market economy is not a zero sum game – an enhanced prosperity for one partner means enhanced prosperity for all. If independence leads to an improvement in the rate of growth of output and employment in the Scottish economy, then the economies of England and of Scotland’s other trading partners should benefit, whether through increased demand for their own output or through lower prices and improvements in the quality of the goods and services they import from Scotland.

Just as trade represents the direct benefits of economic co-operation so organisational co-operation can improve the formulation and implementation of joint economic policies through the introduction of new ideas. For example Scottish representation on a common financial stability authority might bring a fresh perspective to monetary policy and financial regulation, two areas in which UK performance has been poor in recent years.

A currency union based on sterling remains the most likely outcome following independence because it is in the best interests of not just Scotland but of England as well. This is no doubt why Sir James Mirrlees and his colleagues on the Fiscal Commission Working Group recommended it. The advantages to the rest of the UK are significant:

First, the elimination of transactions costs. After independence Scotland should remain the second largest export market for England after the United States. English businesses that export to Scotland will expect that they should not have transactions costs unnecessarily thrust upon them.

Second, compared to having a separate currency there is no exchange rate risk. This means that cross-border investment, competition and specialisation are all encouraged.

Third, a currency union should enhance financial stability.

It has been suggested that to work properly, a currency union requires political union, but the historical experience of those monetary unions between sovereign states that have been successful provides evidence to the contrary.

A formal currency union does, however, require well-designed governance arrangements to be successful. The Mirrlees Commission advocated the establishment of an agreed framework for fiscal stability as well as a consistent regulatory structure for financial institutions. What the former means is agreed limits
on government budget deficits. Budgetary restraint is of course something that all responsible governments should pursue. Having a binding international agreement makes a necessity of virtue, and thus provides political cover for it.

Financial stability is the desired outcome of monetary policy and financial regulation.

Scottish representation on the monetary authority of a continuing currency union should contribute to policy parameters more tailored to economic growth outside London, including the North of England.

Financial regulation can be divided into two areas:

- Supervision and oversight, and
- Crisis management, Resolution and Deposit Protection

In the run-up to the financial crisis of 2007-8 there were significant policy errors in both these areas by the UK authorities. The failure of regulators to monitor risks within individual financial institutions, together with the perverse incentives to imprudent behaviour that encouraged the belief among some bank directors that their institutions were too big to be allowed to fail, and would be bailed out by the state, were key factors contributing to subsequent banking insolvencies. The failure of the Financial Services and Markets Act 2000 to put in place mechanisms for the resolution of problems of potential banking insolvency created contingent liabilities for the British taxpayer.

This lesson now seems to have been learned, and the UK and Europe are moving in the direction of replacing the principle of ‘bail-out’ by the taxpayer with ‘bail-in’ by management, shareholders and creditors\(^1\). In this connection, we should remember that the UK Government’s support for RBS and Lloyds in 2008 and 2009 was part of a series of decisions designed to support the stability of the UK financial system as a whole, and not just the Scottish banks.

It would be quite possible for Scotland to keep the pound following independence without entering into any formal currency union. Indeed, this would not only be possible but, if Scottish interests alone were to count, it would be desirable. It would deliver the main benefits of a currency union – low transactions costs, no set up costs, no exchange rate risk, without some of the costs.

This was the course of action followed by Ireland when it left the UK in 1922. Pounds sterling continued to circulate in Ireland until 1979, when it chose to introduce its own currency before adopting the euro in 2002. In a number of Latin American countries today, notably Panama, Ecuador and El Salvador, the official currency is the US dollar. This takes place without any agreement with, or interference by, the Federal Reserve Board in Washington. Likewise, Scotland could continue to use the pound sterling without requiring the agreement of the Bank of England or any organisation outside the country. The Bank of England would not act as a guarantor for Scottish

\(^1\) The key feature of the approach is that it would impose losses on the management, shareholders and unsecured creditors of a failing bank before taxpayer funds were put at risk.
banks or the Scottish Government. This is an advantage, not a disadvantage. It was precisely the implied promise of a bailout from the European Central Bank that allowed so many Eurozone banks and governments to get themselves into a crisis of excessive debt.

Many people imagine that without a central bank to act as a lender of last resort the result would be financial instability. The historical evidence suggests that the reverse is true. Ireland experienced no bank failures between 1922 and 1979. Despite not having a central bank until 1935, Canada had no commercial bank failures during the Great Depression. Panama, which has always used the US dollar as its domestic currency, is said to have the seventh soundest banking system in the world. Ecuador and El Salvador have both experienced an improvement in the overall stability of their banking systems since adopting the dollar as their currency. Adopting the dollar has played a significant role in improving bank liquidity and asset quality in these two countries. Finally, it should not be forgotten that between 1716 and 1844 Scotland had one of the world’s most stable and robust banking systems. It had no central bank, no lender of last resort, and no bank bailouts. If banks did fail, it was shareholders, not taxpayers, who were liable for paying back depositors. Were it to go down the route of adopting sterling unilaterally, Scotland could end up with a banking system as good as it had before 1845.

But if it were to take account of the interests of the UK as a whole then a formal currency union would undoubtedly be preferable.

Professor David Simpson
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