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ECONOMY, ENERGY AND TOURISM COMMITTEE

Wednesday 12 March 2014

Session 4

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ECONOMY, ENERGY AND TOURISM COMMITTEE

7th Meeting 2014, Session 4

CONVENER

*Murdo Fraser (Mid Scotland and Fife) (Con)

DEPUTY CONVENER

Dennis Robertson (Aberdeenshire West) (SNP)

COMMITTEE MEMBERS

*Christian Allard (North East Scotland) (SNP)
*Richard Baker (North East Scotland) (Lab)
*Marco Biagi (Edinburgh Central) (SNP)
*Chic Brodie (South Scotland) (SNP)
*Alison Johnstone (Lothian) (Green)
*Mike MacKenzie (Highlands and Islands) (SNP)
*Margaret McDougall (West Scotland) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Dr Monique Ebell (National Institute of Economic and Social Research)
Sir John Gieve (University College London)
Professor Ronald MacDonald (University of Glasgow)
Joan McAlpine (South Scotland) (SNP) (Committee Substitute)
Professor Anton Muscatelli
Professor Jeremy Peat (David Hume Institute)

CLERK TO THE COMMITTEE

Stephen Imrie

LOCATION

Committee Room 4

Scottish Parliament

Economy, Energy and Tourism Committee

Wednesday 12 March 2014

[The Convener *opened the meeting at 10:00*]

Scotland's Economic Future Post-2014

The Convener (Murdo Fraser): Good morning, ladies and gentlemen, and welcome to the seventh meeting in 2014 of the Economy, Energy and Tourism Committee. I welcome members, witnesses and the visitors in the public gallery. I remind everyone to please turn off—or at least turn to silent—mobile phones and other electronic devices so that they do not interfere with the sound equipment.

We have apologies this morning from Dennis Robertson, and we are joined by Joan McAlpine as his substitute.

Item 1 on the agenda is a continuation of our inquiry into Scotland's economic future post-2014. We are joined by a distinguished panel of witnesses, whom I will introduce from left to right: Sir John Gieve is a visiting professor at University College London; Professor Ronald MacDonald is Adam Smith professor of political economy at the University of Glasgow; Dr Monique Ebell is a research fellow at the National Institute of Economic and Social Research; Professor Anton Muscatelli is the principal of the University of Glasgow but is here in a personal capacity; and Professor Jeremy Peat is director of the David Hume Institute. Good morning and welcome to you all.

We hope to run the session for about 90 minutes and aim to finish about 11.30. Because we have a large panel, I will not to ask you to make opening statements—we will just go straight to questioning. Although we have a bit of time in hand, I remind members to keep their questions short and to the point, if they can; if we could have answers that are equally concise and to the point, that would be very helpful.

I ask committee members to address their questions initially to a particular member of the panel rather than to all five members. I say to panel members that if you want to respond to a question that has been directed at somebody else—particularly if you strongly agree or disagree with a point that a fellow panel member has made—just catch my eye and I will bring you in as time allows.

I will start by addressing a key point to all of you, which I would like each of you to take a couple minutes to address. In your view, what is the optimal currency arrangement for an independent Scotland? In addition, what would be the optimal currency arrangement for the rest of the United Kingdom in the event that Scotland voted for independence?

We will start with Sir John Gieve and work our way along the panel, getting two or three minutes from each of you on the issues.

Sir John Gieve (University College London): On the question of what would be best for an independent Scotland, I think that it is understandable that the Scottish Government thinks that a formal currency union in which the Bank of England remains the central bank and—probably—the prudential regulator for Scotland as well as England, with some joint governance arrangement, looks attractive. That would certainly be optimal to begin with, because the economies are highly integrated. Over time, it is likely to get less optimal and, as others will undoubtedly say, the different weight of oil and gas, in particular, could make it uncomfortable, even then, to have a currency union whose policy will be adapted, as it is today, largely for the rest of the UK.

From an RUK point of view, I cannot see any real reason why it would be in the rest of the UK's interest to agree to a formal currency union on anything other than exceptionally controlling terms. If Westminster retained effective control of fiscal policy in Scotland as well as of monetary policy, that would be acceptable, but that is unlikely to be acceptable politically in the north.

The rest of the UK would probably prefer an informal currency union—one in which it would have no legal obligations to Scotland and would rely on the markets to constrain Scottish policy—to a formal currency union. A separate currency would not worry it hugely.

The Convener: I just want to be clear—by an informal currency union, do you mean Scotland using the pound sterling, in the same way that Panama uses the dollar?

Sir John Gieve: Yes. It is a sort of Irish solution. Ireland used the pound sterling for 50 years after independence, although the situation and the economy were very different. In effect, it had a currency board that was backed one for one with British notes. Under that type of arrangement, the institutions in London would have no legal obligations to support, monitor or negotiate policy with Scotland.

Professor Ronald MacDonald (University of Glasgow): My starting point is the fact that we have had a long-standing monetary union in the UK for more than 300 years. What we have seen and what most commentators have noted is a considerable amount of convergence in that time. Productivity differentials and gross domestic product per capita are very similar at the moment.

To design a suitable policy for an independent Scotland, we need to look at what the economy will look like post-independence. There are a number of reasons to believe that, as Scotland moved away from unity with the rest of the UK, things would start to diverge. For a lot of variables such as productivity, that process may take some time, but one thing is for sure: on day 1 of independence, Scotland will have diverged quite significantly, because if it gets its share of North Sea oil, it will become a commodity producer and a net exporter of hydrocarbons, to boot.

That is highly significant in a Scottish context. At the moment, Scotland has a very rich and wide traded sector that is non-oil. The problem with having a commodity as part of your traded bundle is that the shocks that hit commodity prices are different from the shocks that hit the rest of your trade. If Scotland were to be part of a monetary union post-independence, it would not be able to deal with oil shocks, which would have significant knock-on effects on its non-oil sector. That would affect that sector's competitiveness, which is the crux of any hydrocarbon-producing country. Gulf countries and, indeed, any country that is a net exporter of hydrocarbons face that problem, which is usually referred to as the resource curse. It can be seen most clearly in Norway.

The only option that I can see for an independent Scotland is a separate currency. Nothing else will work; nothing else will be credible to markets. That is the only option for the rest of the UK as well. Much is made of the transaction costs that would apply for the rest of the UK, but those costs are well known to be very small relative to the potential costs of a monetary union breaking up. There are big issues with the credibility of statements that have been made about any potential monetary union, but perhaps we can return to that later.

Dr Monique Ebell (National Institute of Economic and Social Research): I agree that the most appropriate currency choice for an independent Scotland would be for it to have its own currency, mainly because that would give Scotland the greatest capacity to react to shocks. That is particularly important given the level of debt with which Scotland is likely to begin its life as an independent country, for the simple reason that if monetary policy is shut down, the ability to react to shocks becomes restricted to fiscal policy: debt can be increased or some sort of austerity policy can be run. Given the likely level of debt, increasing debt further might be rather difficult and quite expensive.

Therefore, being in a monetary union would narrow Scotland's range of policy choices dramatically, and I cannot imagine that that would be in the best interests of an independent Scotland.

As far as the rest of the UK is concerned, I agree with Sir John Gieve and Professor Ronald MacDonald that it is difficult to see how a formal monetary union that would involve sharing the Bank of England would be in the interests of the rest of the UK, simply because it would involve the rest of the UK taking on the role of insurer to a sovereign country.

The UK as a whole decided at some point to remain outside the European monetary union, despite the fact that it trades quite substantially with the rest of the European Union. Hence, the UK has already decided that the transaction costs of staying outside the European monetary union are small enough relative to the risks involved in joining it. From that perspective, it is credible not to wish to join a sterling zone.

On what would be optimal from the perspective of the rest of the UK, I would have to say that it would be Scotland having its own currency, simply because that would put Scotland on the most stable footing in terms of fiscal policy and its financial sector.

Professor Anton Muscatelli: As the committee will have seen from my written submission, I take a different view: I strongly support the fiscal commission working group's view that a sterling currency union between the rest of the UK and Scotland would be optimal for both sides immediately following independence. There are a number of reasons for that. The issue is partially about transaction costs, which, as I say in my submission, are difficult to estimate but could be substantial. However, it goes beyond that to other costs that cannot be easily estimated and that would have a considerable impact on both sides, given that there is such convergence.

Over the medium term, a different arrangement might be optimal, but that would take a considerable amount of time. Some of the views on the optimality or otherwise of a monetary union have been influenced by what has happened in the European monetary union in the past few years but, as I explain in my submission, the situation between Scotland and the rest of the UK is very different from that of European monetary union.

As I also explain in my submission, there are a number of other considerations. I will highlight a couple to start with. One is that no monetary arrangement will completely insulate us against shock. Having our own currency or, indeed, an informal monetary union would not in itself solve the problem. There will be shocks that will be transmitted even within monetary unions or different currency arrangements.

The other point is that, if, for whatever reason, a sterling currency zone is not negotiated—ultimately, that will be a political judgment in a political negotiation; it will not just be an economic consideration—there will still be risks to the rest of the UK and Scotland.

For instance, an informal monetary union, as I point out, is very different from what happened in Ireland when it achieved independence or from what Panama and Montenegro are doing at the moment with respect to the dollar and the euro. It is different because Scotland makes up 10 per cent of the overall UK economy. Would the rest of the UK really want a country to be using its currency, informally, on its doorstep, which would mean—let us say—roughly 10 per cent of the UK money supply being used somewhere else? I argue in my submission that it might not be optimal to do that.

Ultimately, there are ways of handling the hydrocarbon problem. An oil fund and smoothing out public expenditure and revenues over time would probably be the way to do that. However, if the option of a sterling currency area, which is the best option for Scotland and the rest of the UK, is not negotiated for whatever reason, the second-best option would probably be a Scottish currency as opposed to any informal arrangement.

10:15

Professor Jeremy Peat (David Hume Institute): Good morning. I start by looking at what I believe would be best for Scotland, which is the provision of sound and stable conditions for economic performance. That is what matters. There is great scope for improvement and progress after what we have been through over the past six years or so. Therefore, I am looking for as much stability as can be achieved.

In principle, one starts with a preference for there being currency stability with the rest of the UK, which is far and away our main trading partner—the extent of corporate and other relationships that have emerged over many centuries is massive. Anything other than currency stability not only would involve significant transaction costs—as Anton Muscatelli has pointed out—and other related costs, but would be likely to involve significant disruption in trading and business relations, which could be quite damaging to Scotland. Stability is extremely important.

The problem is that, as John Gieve has said, stability might be achievable only under what he called “exceptionally controlling terms” that would be set by the rest of the UK. Scotland would have no control whatever over monetary policy, as Ronald MacDonald has said, and even our control over fiscal policy might be severely curtailed. Therefore, Scotland’s access to the two major instruments of macroeconomic policy would be extremely limited within the currency union. One must play off the advantage of currency stability and what is best for the continuation and development of relationships and the development of our economy against the concern that Scotland’s independence of economic policy would be severely curtailed.

That leads me to think that one needs to look seriously at a second option, and I agree with all the other witnesses who are giving evidence today that the only other option that merits consideration is an independent currency. That would permit full control over monetary and fiscal policy, and it would enable a way forward.

However, there would be a risk of significant volatility in our currency and our relationships if we had a newly emerging petrocurrency, which in turn might lead to a need for very tight monetary and fiscal policies. All the evidence that I have seen from David Skilling and others shows that successful small economies run very tight ships as far as monetary and fiscal policies are concerned, and I think that a newly emerging, relatively small economy with an emphasis on oil and gas would be required to run even tighter policies than many successful small economies do now.

I am afraid that I am not going to give you an unequivocal choice. My preference in principle, without doubt, would be currency union, provided that that could be achieved on terms that allowed sufficient independence of policy enaction to enable Scotland to look after its own interests in the emerging environment in which it would find itself. If that was not possible—if the only settlement on the table was, as someone has described it, one that no self-respecting nationalist would accept—one would have to look at the alternative, and the only alternative that it makes sense to examine is an independent currency. That would certainly be achievable, but it is not the soft, easy option.

The Convener: Thank you. That has been helpful in setting the scene. There is clearly a division of opinion, but that is welcome. I now open the discussion to questions. I am sure that we will tease out some more of the issues.

Mike MacKenzie (Highlands and Islands) (SNP): My questions are pretty much for Professor Muscatelli. You say that a comparison between the sterling area and the EMU is not valid. Can you elaborate on that a bit?

Professor Muscatelli: I will make three points.

If you compare the level of integration that exists at the moment between Scotland and the rest of the UK with the level of integration that exists between any pair of countries that you might choose in the current eurozone, you will see a big difference.

There are no border effects at the moment between the rest of the UK and Scotland, whereas the European monetary union was not integrated—in a sense, it started off as a set of very different countries with a high volume of trade flow but still with substantial border effects. When a common currency was introduced, there was a mismatch with the existing level of integration, whereas Scotland and the rest of the UK start from a very different position—we start from a high degree of integration. Value chains between businesses are highly integrated and the volume of trade flows from both sides is absolutely huge. I cannot remember the figures off the top of my head, but Scotland is the second-largest trade partner for the rest of the UK, and the volume is absolutely huge.

Of course, the fiscal rules and governance of the European monetary union were deeply flawed. Immediately after the creation of the monetary union, a number of people pointed out that some of its fiscal rules were asymmetric and not sufficiently tight. The way in which the accession rules were softened meant that the eurozone did not start on a great footing.

The situation for the rest of the UK and Scotland is totally different. We have co-ordinated economic cycles and similar levels of productivity. As others have said, that starting point is very different and the situation is not likely to change dramatically over time, particularly if a currency union is maintained. If a currency union is not maintained, that will impact on the degree of integration, but if it is maintained, the integration is likely to persist.

One point that has sometimes been ignored is that, immediately after independence, if there is a sterling monetary union, there will have to be fiscal rules for both Scotland and the rest of the UK and, interestingly, we would start from a mutualised debt position, which does not exist in the European monetary union. The most likely arrangement—in a sense, this has been confirmed by recent statements from the UK Government—is that the rest of the UK would be responsible for servicing the debt, but Scotland would of course contribute towards the interest payments and would only issue its debt over time. The average maturity of UK debt is very long. There has been much talk in the EMU about the possibility of euro bonds, common bonds and common finance. In a sense, the situation here would be a loose, but not quite exact, parallel. We would start from a mutualised debt position, which would unwind slowly over time.

Those are three points that highlight how different the European monetary union is from a potential sterling currency zone.

Mike MacKenzie: That comprehensive answer has anticipated some of my questions, so it might have saved some time.

Would a sustainability agreement allow scope for fiscal flexibility? What would be the limits of that for Scotland after independence and for the rest of the UK?

Professor Muscatelli: There would need to be two broad fiscal rules. Certainly, there would need to be one rule governing the deficit. As I said, the rule that was put in place in the eurozone was not satisfactory, because it was a deficit ceiling. Ideally, we would probably want a deficit rule that maintained the structural budget balance over the economic cycle. That would apply to both partners.

The other rule would be on debt sustainability. Again, I would not necessarily formulate that in the way that the eurozone did, by setting a 60 per cent debt ceiling. Frankly, very few of the Organisation for Economic Co-operation and Development countries would be able to satisfy that rule. The issue is more about debt sustainability and ensuring that the debt to GDP ratio can be managed over time.

Those are the two key rules. Within that, the two countries could run very different fiscal policies. Say, as a hypothesis, that Scotland wished to run a more progressive income tax policy and very different welfare and labour market policies. The key thing is that there has to be a rule on deficits or budget balance and a rule on debt sustainability. Those are the envelopes that have to be set. Within them, the countries could run different policies on taxation and spending.

Mike MacKenzie: You are probably aware that calculations by the National Institute of Economic and Social Research suggest that, after independence, Scotland would have a debt to GDP ratio of about 81 per cent, whereas the rest of the UK's would be 104 per cent. Would that have implications for a sustainability agreement and for the way in which each country could live within it?

Professor Muscatelli: Clearly, the starting position will depend on a negotiation on the debt. As you said, the figures that you cite came out of one configuration of the National Institute of Economic and Social Research paper on the subject.

It is less important to focus on the debt to GDP ratios that we would start with and more important to focus on debt sustainability. The key thing for both parties and, indeed, for the monetary authority that would run the sterling currency union—the Bank of England—is to ensure that the debt path is sustainable. That is partly dependent on the starting position, but to a large extent it also involves looking at issues such as growth rates over time and the real interest rate, and it is also to do with prospective medium-term fiscal policy.

The starting point would need to be taken into account, but it is about more than that. I would focus less on the initial debt to GDP ratio and more on the package around debt sustainability.

Mike MacKenzie: Thank you.

The Convener: Chic Brodie wants to ask a question, but first I say to other members of the panel that this is not question time with Professor Muscatelli, refreshing as it is to hear his views. If others wish to come in and express an opinion, they should catch my eye and do that.

Professor Peat: I will add a small point to what Professor Muscatelli said. A complication for the rules on both deficits and debt sustainability would be what assumptions to feed in with regard to oil and gas revenues, given that they would be a high percentage of expected revenues and are, to a degree, uncertain. One would have to determine what projection to use and what percentage of that projected revenue to take into account in agreeing any forward-looking, anticipated deficits and debt levels.

Nobody knows what the levels of oil and gas revenues are going to be in the future, and there can be wide variations in the estimates. There would need to be a way of dealing with that and, first, getting a view of at least the range of those revenues, and, secondly knowing to what extent to take account of them within the deficit and debt rules. That complication would need to be addressed.

Sir John Gieve: I strongly agree with that. The cycle that matters is the future cycle rather than the past. In the UK, we saw the dangers of redefining the cycle in the past to try to make the books balance. It is the next one that counts, and what happens to oil and gas will be key to that.

I agree with Professor Muscatelli that the fiscal rules in the euro area are deficient and that they should be more symmetric, but it is quite a big ask of the rest of the UK that its fiscal policy and stance should be governed by some supranational arrangements that are vetted by an independent body appointed by both Governments. That illustrates why a formal currency union may be quite difficult to negotiate.

Dr Ebell: I take up Professor Muscatelli's point that Scotland and the UK are well integrated in their goods markets, but also in their capital markets. It is important to remember that the high degree of integration of the capital markets might work against the stability of a currency union. The reason is that, if Scotland's continued membership of the currency union was to suffer a weakness in credibility at any point, we could expect capital flight to be a real issue due to the highly integrated capital markets.

We have an historical example of that. The Czech and Slovak economies were also highly integrated, with highly integrated capital markets. Upon the velvet divorce, the Czech and Slovak Governments agreed a formal monetary union that involved sharing a central bank, but within weeks there were expectations that the monetary union would not be long lasting and would not endure. We saw a substantial amount of capital flight, and as a result the monetary union had to be dissolved. Although trade integration is surely an important component in making a monetary union sound and sustainable, capital market integration might actually work the other way.

10:30

Professor MacDonald: I want to follow up on a point that Dr Ebell made, which I think is crucial to the sustainability of a potential monetary union post-independence. For a financial regime to fly with financial markets and capital markets, it has to be credible. The signal that we have from the Scottish Government is that this is a short-term arrangement. Indeed, I notice that Professor Muscatelli, in his evidence, implicitly assumes that it is a short-term arrangement as well.

The Czech-Slovak example is quite a good one. We know that you have to make an irrevocable commitment to a peg for that peg to work, and that commitment has not been given. Indeed, a statement to the contrary has been given by the Scottish Government, which has said that it is open to it, on day 1 of independence, to choose another exchange rate regime. That leads me to my second point, which concerns the resource curse that I mentioned.

I noticed in the fiscal commission's document and in our discussions today that the focus is always on the effect that oil has on the budget deficit of an independent Scotland. The focus is never on the effect that it will have on the non-oil sector, which, to me, is the crucial thing. That will make any monetary union unsustainable. If it is unsustainable in two or three years' time, it is unsustainable today, because that is how capital markets work, particularly if there is no irrevocable commitment to a monetary union, which, indeed, is the case today.

Professor Muscatelli: I would make two points. In the case of the Czech Republic and the Slovak Republic, one of the problems with monetary union was that there was no attempt to co-ordinate fiscal policy, which has to be the cornerstone of any agreement. That brings us back to the point about there having to be a comprehensive agreement.

I am much more optimistic on the issue of whether the arrangements have to be permanent. I agree that markets tend to react to one-way bets—we saw that with the European exchange rate mechanism. However, they do not react to uncertain regimes that might change in 15 or 20 years' time. My personal view is that, if a sterling currency union were chosen, the degree of trade integration would persist for quite a long time. You would not see border effects emerging very quickly.

The issue is actually quite instructive. Governments always think that the monetary, fiscal and macroeconomic regimes that they put in place will last for ever. However, since 1979, the UK has had about six macroeconomic policy regimes, none of which brought about one-way bets when they were instituted. Mrs Thatcher introduced what was effectively a monetarist-type model in 1979. It was abandoned in the mid-1980s because the monetary targets did not work, so more eclectic targets were used. We then moved to shadowing the Deutschmark, and then to the ERM. After we exited the ERM, we went to using inflation targets, but with monetary policy controlled by the UK Government. Finally, we went to having an independent Bank of England. When each of those regimes started, the market never said, "My goodness. There will be a problem in five or 10 years' time, so we will therefore take a one-way bet."

The point is, will there be a one-way bet? That relates to the likely shocks that could hit a sterling currency union. There could be a major oil discovery in Scotland five or 10 years after independence, but there could also be a shock the other way. However, unless there is a one-way bet, it is unlikely that those issues would arise immediately. There would be issues that would need to be managed over time. That is why I come back to the question of how you would set up an oil fund and the fiscal rules. Those issues are critical to the design of a currency union and would need to be addressed as part of that.

The Convener: I know that other panel members want to speak, but we need to get some more questions in and move things on. We could just sit back and let you all debate among yourselves for the next hour and a half, of course, which might be quite interesting. However, I think that we have to justify our position.

Chic Brodie (South Scotland) (SNP): Professor Muscatelli has just made a comment about the possibility of more oil being found, and we must remember that it is not just the North Sea that we are talking about and that there are more opportunities in Scotland's waters.

In his refreshing document, Professor Muscatelli talked about the choices for the rest of the UK in the event of independence. I have a question on that point for Sir John Gieve and Professor Muscatelli.

In October, the governor of the Bank of England said that, in the next 30 years, it is possible that the assets of the banks will be nine times the GDP of the UK. We talk about volatility, but are you scared about what might happen to the UK economy—if Scotland votes no, it will be part of the UK economy—if we have one sector that has that amount of asset capability and sucks resources from the rest of the UK's capability to produce and export? I will come back to the issue of resource with Professor Peat in a minute,

My second question is on a related point. I got the Government expenditure and revenue Scotland figures this morning. Scotland's performance relative to that of the UK shows that, even with the drop in oil revenues—which was caused in part by a record tax-deductible £14 billion of investment spending by oil companies—Scotland's current budget balance, at 5.9 per cent of GDP, is almost identical to that of the United Kingdom. Our trade situation is much better, because we have a surplus as opposed to the UK's huge deficit. Looking at the position through a UK frame of reference, what would happen if such large assets were concentrated in one sector and there was a not very good financial performance and a trade, or, indeed, fiscal deficit in the rest of the UK?

Sir John Gieve: That is really quite a suitcase of a question.

The Convener: A large suitcase, I thought.

Sir John Gieve: I think that Mark Carney's point was not just that we were going to see the financial sector grow to a great extent but that that in itself did not scare him and that, provided regulation was strong enough, it could be made safe. My personal view is that I would be worried if the sector got to that scale. In the financial crisis of 2008-09, we came very close to having banks that were too big to save, let alone too big to fail. Famously, in Ireland and Iceland, the banks were too big to save. We and the Swiss were quite close to that position, but as it turned out we were able to save them. However, I think that it would have been a potential problem if the banks had been twice as large again. I am perhaps a bit less relaxed than the governor of the Bank of England is about that.

Mr Brodie asked about whether large growth in the finance sector would mean that the whole economy would be unbalanced and would be running a chronic trade deficit. Certainly, growth would be concentrated in the finance sector if it grew to that level, but it would have to grow to that level on the back of being an international financial centre that sold its wares abroad. Therefore, I do not think that it follows at all that the current account deficit would get ever bigger. The sector would be a source of invisible export earnings.

Does that answer at least half your question?

Chic Brodie: It answers half of the question, but I would like to come back to Professor Peat on the other aspect—the concentration of resource, and productivity and innovation being denied the rest of the country.

Professor Peat: Would you like me to answer?

Chic Brodie: Yes, if you do not mind.

Professor Peat: I start from the position of looking at what Scotland wants from the banking sector in order to aid its performance and the development of wellbeing—defined broadly—in Scotland. Two aspects seem to me to be important. The first is the facility to lend and service the requirements of households and businesses in Scotland. Most of those businesses are relatively small, and one hopes that some of them are growing and innovating, but not as many are doing that as one would wish, as I state in my small note to the committee.

Also, I still think that there is a huge problem with the lack of utilisation of higher education research activity and the development of that into burgeoning, competitive and productive exporting businesses. One answer to the question why there is not enough of that might be the finance issue. I look to the financial and banking sector to provide a vigorous and competitive source of funding and support for households and businesses in Scotland. That would involve access to some investment banking facilities for the very largest corporates, but it is mainly good old retail, corporate and commercial banking that I am looking for.

I would like to see a wider proliferation of banks entering the market so that we can get away from the broad duopoly of banking in Scotland at the small and medium-sized enterprise level towards a more competitive and therefore beneficial market. I know that Holyrood committees have said some things about that, and I welcome that. I remember that, when I gave evidence to this committee about three years ago, I talked about how I wanted to see many flowers grow. At the same time, I said that I thought that the Royal Bank of Scotland's centre of gravity had moved south. That was true then and it is increasingly true now.

The other advantage that Scotland can get from the banking sector is having head office type functions that help to develop our professional services and business services sectors in a way that benefits other growing companies, so that we have the right highly skilled lawyers, actuaries and accountants here in Scotland, rather than those people coming up and down on the plane from London, as was the case many years ago and might increasingly be the case now.

I look for those two benefits. I would like to see more head offices of small retail, commercial and corporate banks in Scotland. That could have the dual effect of providing banking services that can help and helping to stimulate the financial and business services sector. As well as that, it could provide a labour market that shows people that they can have a career here in which they can grow and develop. Those are the advantages that I see.

I am not sure what the advantages are to Scotland of having a nominal head office here that has associated with it risks that are largely related to investment banking activities that we are not particularly interested in. If the head office of RBS and/or HBOS was to formally move out of Scotland, I am not sure what the loss would be to Scotland and our economic interests; I would need to look at that more carefully. I would be worried if we did not have a competitive financial sector or if we did not have a sufficient head office base to stimulate financial and business services. However, I am not particularly worried if investment banking—casino banking—and its associated risks stick in London.

I emphasise that I left RBS in 2005, before the recession, but I have watched what has gone on since then, and I stick to the view that the banking sector can bring those two real benefits to Scotland. We need to think about what we want and how we can encourage that to the benefit of our economy.

The Convener: I have a follow-up question. Professor Peat, you mentioned RBS, of which you are a former chief economist.

Professor Peat: Long-time former.

The Convener: Do you have a view on Mark Carney's comment yesterday that, in the event of independence, there is a distinct possibility that RBS will have to move its head office south of the border?

Professor Peat: I have not read his remarks in detail and I have not spoken to anyone about them, but it would not surprise me in the slightest if contingency plans are in place for RBS and other financial institutions and significant corporates to move their head offices. If they look at the risks of staying compared with the risks of moving, they might find that the bet is skewed in one direction.

Chic Brodie: Is it not the case—I know that it is for one bank—that when these banks talk of moving down south, they are talking not about moving their operations but about setting up a small holding company for tax purposes? I know that that is happening with other institutions. A bit of clarity is required around that kind of statement about RBS moving to London when, in fact, it might be setting up a holding company with about 20 people in it.

Professor Peat: RBS employs slightly more than 20 people in London. One could envisage those who run the Scottish operations and some aspects of the overseas operations that could be run efficiently from here—a lot of aspects could be run efficiently from here—being left at Gogarburn while the formal head office for financial regulation and other aspects is taken away from Scotland. That scenario may be under consideration.

10:45

The Convener: I will let Sir John Gieve and Monique Ebell respond, then we will have one more question from Chic Brodie.

Sir John Gieve: I very much agree that it is not necessary to move thousands of people and lots of kit south of the border. However, if an institution formally moves its headquarters outside Scotland, there is a risk that, over time, a greater proportion of the high-salaried posts will move south.

There are three powerful reasons why all the financial institutions in Scotland will consider doing that. First, there is the powerful consideration that they would be dealing with a regulator that they already know—the devil they know. Over many years, all the institutions will have reached accommodations on a host of regulatory questions, so it would be no small thing to switch to a new, unknown regulator.

Secondly, the regulator that regulates them at the moment has quite a powerful voice in international financial rule making. Notably, Mark Carney is the head of the Financial Stability Board and he carries greater weight in Basel and Brussels than a new Scottish regulator would.

Thirdly, and most important for the banks, their credit rating still depends to some degree on the credit rating of their home Government. They will be worried that keeping their main headquarters in Scotland could lead to higher costs of funds for their own borrowing.

Dr Ebell: I want to take up Professor Peat's point about the financial sector and make a link back to the currency choice—in particular, to the viability of the so-called plan B of an informal currency union. It is important to remember the banks' function of lending to Scottish businesses to allow them to grow. Under an informal currency union, if the large banks moved their operations south of the border, the banks that were serving the Scottish domestic economy would be left without a lender of last resort.

Banks in dollarised economies such as that of Panama deal with that by having much higher capital ratios that are required by any Bank of England or Basel regulation. However, that would put a brake on Scottish banks' ability to lend to Scottish businesses and facilitate their growth. If you are concerned about productivity, that aspect should be considered carefully.

Chic Brodie: I am afraid that that flies in the face of the Standard & Poor's report that was published last week, which mentions that

"Scottish wealth levels are comparable to that of the U.K."

and that

"Scotland would qualify for our highest economic assessment."

It goes on to say:

"The assets of Scotland's banks and building societies ... account for about 12.5x Scotland's mainland GDP versus an estimated ... 4.6x in the U.K.".

Dr Ebell: I think that you have misunderstood my point. I am saying that, if Scotland were to dollarise—if Scotland were to enter an informal currency union with the rest of the UK—Scottish banks would not have a natural lender of last resort. A lender of last resort is generally a central bank that can print money. Put in simpler terms, Scottish banks would be left without an insurer and would have to self-insure by holding greater reserves.

I am not talking about the state of the Scottish banking industry currently; I am looking forward to the possible scenario of dollarisation. Banks would deal with the situation of being left without an insurer by self-insuring—by holding higher capital reserves—which would leave them with less capital to lend to Scottish businesses, and that might have an impact on the growth of Scottish firms.

The Convener: We must move on. I am conscious of the time. We are already more than halfway through the evidence session and we have got through only three members' questions, so we will need to sharpen up a bit, if we can, with our questions and responses.

Margaret McDougall (West Scotland) (Lab): Good morning, panel. Professor MacDonald, you suggest in your written evidence that

"sterlingisation would give Scotland the economic status of a failed state."

Does that mean that Alex Salmond should find a new plan B for the currency?

Professor MacDonald: As I have argued previously, the short answer to that is yes—very much so. I believe that any form of sterlingisation, including a formal or informal currency union, would be affected by the issues that I mentioned earlier with regard to oil shocks. We would enter a completely different scenario if we were independent. Professor Muscatelli mentioned dealing with that through an oil fund, but in practical terms, an independent Scotland would have to build up such a fund, and I do not know how many years that would take.

We must also remember that oil shocks affect a country's terms of trade and the overall level of demand and income. As the Norwegian experience shows, if a country is going to use an oil fund or a sovereign wealth fund to control those terms-of-trade shocks, it must have a separate currency.

No matter how one cuts it, the issue of the resource curse and the asymmetric shocks that are introduced by oil being the dominant force in the country's terms of trade must be addressed. Any form of sterlingisation would be bad news, and the options for what we call dollarisation and a currency board would be even worse news than simply having a currency board. I said that sterlingisation would be a sign of a "failed state" because the country would not be addressing the central issue. Eventually, if it was not addressed by the time the oil was depleted, the country would have no export sector that was not based on oil. That is the reality.

Margaret McDougall: The view from most of the panel members in their opening remarks was that there should be an independent currency. Professor Peat, you said that you would prefer an independent currency if monetary union could not be negotiated, that there would be difficulties around that, and that there would have to be a tight fiscal policy if there was an independent currency.

Will you explain for the non-economists such as me what that would mean for the man and woman in the street? Would it mean higher taxation and lower public service provision?

Chic Brodie: It could be the other way round.

Professor Peat: It is that way round.

On the point about dollarisation, that would meet my first criterion of providing stability—at least initially—in the exchange rate, which would benefit Scotland. However, reading a number of comments and examining a number of examples of success, as it were, with dollarisation around the world has led me to share the other panel members' view that it would be a difficult option to proceed with and it would potentially lead to a lot of adverse effects.

That leads me to believe that, if a currency union is not feasible, having our own currency is the answer. However, a tight fiscal policy would be required, which would mean having relatively high taxes and low public finances in order to secure a low or non-existent deficit year on year and to reduce over time, at a reasonable rate, the debt level relative to GDP. That would probably apply to each of the options that one considers.

The difficulty is that, as others have mentioned, a newly emerging country that has a new currency or is trying to tie itself to another currency needs to establish credibility. For a country to do that, particularly when a lot of its revenue comes from a volatile and uncertain source such as oil and gas, revenues from which may go up sharply but may also go down, it would have to run a tight ship. It would need to prove that it could manage its public finances sensibly, get its deficit down to low levels and keep it low, and get its debt to GDP ratio down.

Whether the country had a currency union, sterlingisation or an independent currency, it would, at least initially, have to run a tight fiscal policy in order to prove its credibility to the financial markets, and if it wanted to maintain a relatively stable currency when it was independent, it would probably need a tight monetary policy with relatively high interest rates. One has to look at both those instruments and consider that, in the initial years, proving credibility would involve being quite rigid.

Margaret McDougall: Does that mean that we would expect higher taxation through income tax, for example?

Professor Peat: The choice of how to achieve a lower or a zero deficit—whatever the target was—would be for the Government to make as it managed public expenditure and the different elements of taxation. The end product that would be required would involve a story on the public finances being seen to be tight and sustainable and therefore credible as a long-term solution. Exactly how the individual elements would be managed would be primarily, if not entirely, for the Scottish Government to decide.

Margaret McDougall: It is clear that, in layman's terms, a tight fiscal policy could mean a tightening of belts.

Professor Peat: Especially if there was a requirement to build up an oil fund, as Professor Muscatelli and others have suggested. If a country wants to build up an oil fund for short and long-term stability, it has to take money out of its revenue stream and put it away for a rainy day, or a subsequent day. It therefore has less money to spend on public services than it would have if it did not take that money away.

Given the volatility and uncertainty of oil revenues, it makes sense to establish some form of oil fund, but to do so when one is starting with quite tight public finances is difficult and will take time. The more money one squirrels away for later, the less one has to spend now.

Alison Johnstone (Lothian) (Green): Good morning. The Westminster coalition asserted a few weeks ago that there would be no monetary union. Since that happened, we seem to have done nothing but debate all the alternatives. We must think that George Osborne and Danny Alexander are bluffing, or perhaps that they will not even be in a position to influence the decision when the time comes.

It is clear that a lot of Scots will vote yes in the hope of getting divergent policies and because of their frustrations with the current situation. What impact will the currency position have on the ability of Scotland to become a more equal society in the event of a yes vote? I put that question to Professor MacDonald and Professor Peat in the first instance.

Professor MacDonald: Just to clarify, do you mean if we stick with a currency union or under any of the currency arrangements?

Alison Johnstone: I just want to understand what impact the currency decision will have on our ability to become a more equal society. What would be the best currency decision to enable us to address inequality?

Professor MacDonald: That comes back to what I said earlier. For example, I believe that one of the Scottish Government's aims is to improve productivity and economic growth post-independence, and perhaps by doing that one would deal with inequality.

However, the issue then is what the exchange rate regime is, because it is well known that productivity changes have a direct effect on a country's competitiveness, which is, loosely speaking, its inflation relative to that of its trading partners. If the country does not have a mechanism to address those changes in inflation—for example, if it does not have an exchange rate to adjust—its competitiveness will be changing, which will affect its non-oil sector and the sectors that are not affected by the productivity changes.

That is the dilemma that an independent country faces, particularly in the context of the resource, which has to be balanced with the non-oil sector. If it is not, the country risks shrinking its non-oil sector and, as oil is depleted, it will end up without a non-oil sector, which is very bad news.

How do we do such a balancing act? My argument is that it is possible to do it only with a separate currency; it cannot be done in the context of monetary union. It is simply impossible because what of we call terms-of-trade shocks: the terms of trade—the price of a country's exports relative to its imports—will be shocked all the time because of the changes in the price of oil, and that feeds through directly into the country's competitiveness. Those movements in competitiveness in a net exporting country of oil must be dealt with or there will be really serious effects on the country's non-oil sector.

11:00

Alison Johnstone: Thank you very much. I address the same question to Professor Peat.

Professor Peat: If one is in the position of a currency union, one can expect to have what John Gieve called exceptionally controlling terms. The extent to which that involves more than just saying what the public finance deficit and sustainable debt have to be depends on the extent to which the freedom to develop other policies is constrained. If it is simply a requirement that the deficit level shall be X and the sustainable debt over time shall be Y, Scotland will be able to work within that envelope and develop policies that can achieve the objectives that the Scottish Government wishes on behalf of the Scottish people.

To be able to increase equality in Scotland most effectively, the country needs to be productive, competitive and able to grow its economy so that it can use the fruits of that growth to whatever ends it wishes. What really matters is getting productivity and competitiveness up. It is then for the Government, on behalf of the people, to determine how best to deploy the resources—just letting it rip in whatever way or having some views on the balances that are wished for within the society.

If, in the terms that it imposed under a currency union, the UK Government also laid down other conditions, that might limit the scope for Scotland to take divergent policies, which might limit the potential for it to achieve enhanced productivity and growth and might also limit its capability to go for greater egalitarianism. It depends on the deal that can be struck. A deal can always be struck on such things. It is a matter of how tight and constraining it is.

If Scotland moves to an independent currency, the markets and others will judge overall macroeconomic policies in determining whether it is the right approach and whether the currency is sufficiently stable to enable the non-oil sector to develop in the way that Professor MacDonald just described. However, it is unlikely that there would be the risk of other constraints on policies that might be imposed under a currency union.

What really matters is getting the non-oil and gas sector competitive and efficient and getting it to grow in such a way that welfare can be enhanced throughout Scotland in the ways that Scotland wishes. That is why I have emphasised the other part of the question, which is the need to get productivity and competitiveness up. That is what matters at the end of the day and one should see the currency solution in that context rather than as an end in itself.

Alison Johnstone: I will ask Dr Ebell a question regarding her earlier discussion with Mr Brodie. Last week, we heard from Professor David Simpson. He suggested that the lack of a lender of last resort could be positive in some regards in that it would encourage sensible policy from the word go and that, because we would be having a change of emphasis on who to bail out in the future, management, stakeholders and creditors would have to bear the brunt. Do you have any comment on what he told us last week?

Dr Ebell: Certainly. I have two responses to it. The first is that Professor Simpson takes perhaps a rather optimistic view of the loyalty of financial institutions to Scotland. If financial institutions were faced with a choice of a regime south of the border in which they had access to a lender of last resort—which would enable them to maintain lower capital ratios and, hence, lend more of their money profitably—and one in which they would need to be self-insuring to replace that lost lender of last resort, which would be costly to them and would mean that they would have to hold higher capital buffers, have less money available to lend to the Scottish economy and, probably, have lower rates of profit, I am fairly certain where I would go if I were a bank.

That said, there are certainly advantages in respect of financial stability in banks having high capital ratios in the sense that they will then not need to access the insurance that the central bank provides, which is backed up by the taxpayer. That comes at a cost, which is the cost that I tried to describe to your colleague Chic Brodie. Less funds would be available for lending to Scottish businesses and households and to support the growth and productivity that you would aim for.

Joan McAlpine (South Scotland) (SNP): My question is for Professor Muscatelli. The Chief Secretary to the Treasury, Danny Alexander, described transaction costs without a formal currency union as "a relatively small factor". In your written evidence, you cite transaction costs of between £500 million and £2.5 billion-plus for rest-of-UK business if a sterling area could not be negotiated. Is that not rather a high cost for business?

Professor Muscatelli: It is a high cost. I will explain where those figures come from. They are based on the estimates of transactions costs that we have been given in various studies, such as "One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union", which was done by the European Commission. At the beginning, we estimated around 0.1 per cent of gross domestic product as the transaction costs reduction within the European monetary union. I think that there was a Treasury study around the five tests when the UK was considering entering the EMU that put the figure potentially as high as 0.5 per cent. That is where that range comes from. That is not trivial, because those costs do not disappear.

There are other costs that are difficult to quantify, which are essentially to do with the reduction in trade. There is an interesting debate on that, which we see in some of the papers of the National Institute of Economic and Social Research to which Dr Ebell and others have contributed. Having reviewed that literature, I take the view that there would be a substantial reduction in trade if the sterling currency zone involving Scotland and the rest of the UK was abandoned, and there would be a cost to the rest of the UK.

There are certain things that cannot be hedged. One can hedge when there is currency risk, but one cannot hedge an investment decision. For instance, if, after independence, a Scottish company wanted to make an investment in England, or vice versa, not having a common currency would create a risk that could not be hedged that easily.

All sorts of other issues arise. Not finding an agreed framework could lead to other difficulties. Reading the piece that was written by Dr Armstrong and Dr Ebell was interesting. If, following independence, an agreement on issues such as debt negotiation, for example, could not be achieved—I think that the example that was given was the Netherlands and Belgium following 1830—there could be serious impacts on the risk spreads of both countries. Ideally, there should be a negotiated agreement on the currency, but there are costs—transaction and investment costs and a reduction in trade flows—that would have a serious impact on the rest of the UK as well as Scotland.

Joan McAlpine: On the plus points of a sterling union, you said in your submission:

> “there are other benefits ... which are less easy to quantify.”

Would you like to have a stab at quantifying them?

Professor Muscatelli: They are very difficult to quantify. The fiscal commission, for instance, mentioned one factor. If Scotland became the main oil exporter and some of the oil and gas exports went to the rest of the UK—I think that it quantified those exports from Scotland at £13.6 billion—that would have an impact. To the extent that those experts would go to the rest of the UK, that would create a risk on the other side. It is very difficult to quantify the benefits, but I will give you one more quantification. One of the best studies in so-called trade gravity models suggests that a currency union enhances trade by 40 per cent between participating countries, which is actually quite close to some of the original estimates. I appreciate that other studies show different results, but an enhancement of 40 per cent suggests that not maintaining a currency union would have a hell of an impact on the rest of the UK and Scotland in terms of reduced trade flows between us.

Professor MacDonald: All the evidence shows that transaction costs are a small percentage of GDP. They are relatively small in the bigger scheme of things. On the matter of the burden that the rest of the UK will bear, no one has pointed out that, if Scotland had a new currency, all that would happen in the rest of the UK is that businesses would continue to invoice in sterling, so the costs would be borne by Scottish consumers.

We do not know at the moment what the sensitivity of demand for English exports is. I dare say that there would be some fall in English exports—sorry, in rest-of-UK exports—but it is highly unlikely that the demand would fall to zero. Even it did, that is 4 per cent of the GDP of the rest of the UK. That is the worst-case scenario that we are talking about—it is not going to happen, but that is the worst-case scenario. The cost of a currency union or a monetary union that is known not to be irrevocable breaking up will be a huge multiple of that number. If we look at the effects of any recent crisis on the UK economy, we can see that that is unambiguous—the numbers will be much bigger. It is very important to put into perspective those transactions costs and who bears them.

Joan McAlpine: If I could ask one more question—

The Convener: One more.

Joan McAlpine: Dr Ebell, you talked earlier about Scotland inheriting its share of the UK debt, but you talked about that in the context of an informal sterling area. Last week, when Professor David Bell was here and he was asked about debt if Scotland was not the continuing state, he made the point that the debt belongs to the UK. A number of the panellists last week talked about the attractiveness, in their view, of a country starting out with no debt at all. What do you think about that?

Dr Ebell: That is a big issue, of course, and an important one for Scotland. It is important to remember that although in technical terms the rest of the UK would remain responsible for the entire debt, international markets that would be interested in lending to Scotland in the future would certainly be watching to see to what extent Scotland met its obligations with respect to the rest of the UK.

Another important point to remember is that Scotland not honouring its commitments to repay its share of the debt to compensate the rest of the UK both for debt servicing and for repaying its share of the debt principal would certainly also attract the interest of other countries that would be concerned about their own regions deciding to do something similar—to secede or to declare independence and then not honour their share of the debt. Scotland not servicing or not repaying its share of the debt would set a rather dangerous precedent and might not be looked on very kindly by some other countries.

Richard Baker (North East Scotland) (Lab): I have a non-economist question for Professor Muscatelli. You referred to comments by the governor of the Bank of England several times in your submission. Yesterday, the governor told the Treasury Select Committee that Scotland would need currency reserves multiple times the size of its GDP—many billions of pounds—to withstand tests by international markets, whether we are in a currency union or whether we use sterlingisation, which is an awful word. How would that be afforded by a newly separate Scotland?

11:15

Professor Muscatelli: I read, in part, Mark Carney’s comments at the Treasury Select Committee yesterday. I think that his assessment was rather more balanced.

If there were a currency union, there would be a very different set of circumstances, because there would clearly be UK sterling union responsibilities for managing sterling. If you have your own currency, it depends what sort of arrangement you want to have. Small European countries that are not part of the eurozone have different arrangements. As I mentioned in my submission, Denmark shadows the euro and Sweden does not.

Richard Baker: The question is whether a country has the reserves to back up that activity in the market.

Professor Muscatelli: You would need substantial reserves if you had your own currency and you wanted, for example, to maintain something like Hong Kong currently has—a currency board arrangement—vis-à-vis sterling. That would be an issue in that situation, but it would not be an issue if you decided to go with your own currency but to have a managed float. There is no reason why Scotland would not have its proportion of UK foreign exchange reserves as part of the asset and liability negotiations, so there would not be an issue. If you had a currency union, by definition it would not be up to Scotland to manage sterling; it would be up to Scotland and the rest of the UK in partnership to manage sterling. The issue would arise only in a situation in which Scotland had its own currency and wanted to maintain a strict peg to sterling.

Richard Baker: Shocks to our economy are a factor in whether the rest of the UK wants to be in a currency union with us. Professor Muscatelli minimises the dangers of that in his submission, but Professor Peat has talked about the need to deal with fluctuations. The most recent figures show that oil and gas taxation fell from £11 billion to £6.5 billion in just one year, which means that our debt to GDP ratio is higher than that for the rest of the UK. Is that not a difficult situation for an independent Scotland to deal with? Does it not show why the rest of the UK might well express some scepticism about being in a currency union with Scotland?

Professor Peat: The issue is complicated by the uncertainties over future revenue streams. In Parliament at Holyrood a week or so back, Paul Johnson from the Institute for Fiscal Studies gave his extrapolation of debt levels, which showed that the likely Scottish debt to GDP ratio would be higher than that of the rest of the UK in 10 years' time or whenever. However, other perfectly viable extrapolations tell a different story.

The clear problem is that we do not know what the level of oil and gas output or the prices will be over the next 10 years—they have moved substantially in recent years. We have had very high levels of investment in the recent past and we have expectations of high levels of investment going forward. That is excellent, but we do not know what that means when it comes to production from existing reserves or finding new reserves that are viable at whatever price. We do not know what the volume of output or the price will be, so a significant share of Scotland's public revenue is uncertain and volatile. As I noted when talking about the way in which public finance rules might have to be set up, that causes issues. As Anton Muscatelli said, it also potentially adds to the problems if you are trying to maintain a fixed peg in an independent currency. If you have those uncertainties, that adds to the difficulty of managing a peg and may add to the need to have high levels of reserves and to have quite tight policies to manage it.

If one went with an individual currency, I would prefer—for the reasons that I have mentioned previously—a system where the relationship with sterling was kept fairly stable, but that might prove very problematic and a managed float without the desired relationship with sterling would be easier to manage from both a currency reserve point of view and a fiscal policy point of view.

Richard Baker: I have a final brief question for Professor Peat, who has worked at a senior level in Government departments. On the panel today, apart from Professor Muscatelli, we have heard either downright opposition to a currency union or very lukewarm support for it, but there has been very broad agreement that a separate currency—a new currency—would be a viable plan B. Is it not extraordinary that the Scottish Government's approach is not to propose a plan B because it thinks that the UK Government is not serious? Would it not be better for the electorate, the markets and everyone else to have a clear plan B, particularly given the evidence that we have heard today?

Professor Peat: I am a great believer in transparency and in careful evidence-based analysis. It is right to give proper scrutiny to the arguments that the Treasury and others have put forward about a currency union. I do not believe that anything is impossible. There are ways of doing it, but the terms might or might not be acceptable. Therefore, it is appropriate to look at the alternatives. We have been doing that, as have many other people. The trouble is that there is no straightforward slam-dunk solution that is there for us all to grab at.

That is why it is right for us to look at sterlingisation, which some might argue is feasible, and to look at having an independent currency, with or without a peg to sterling. All those actions need to be considered. I am all in favour of the National Institute of Economic and Social Research, David Bell, Anton Muscatelli, Ronald MacDonald and all the high-quality academics who are involved giving their views and trying to clarify so that we can all form a firm view of the genuine options and the costs and benefits that might be associated with each of them.

Christian Allard (North East Scotland) (SNP): My question is for Professor Jeremy Peat. This morning, we have heard a lot about what an independent Scotland might bring and what the downside might be. I have lived here for 30 years and I have seen how much the decline in manufacturing industry over that time has affected the UK and in particular Scotland. We have heard that the Scottish economy is varied and prosperous but, unfortunately, we have lost ground in the manufacturing sector. How can we explain the current account deficit in the UK for 29 of the past 33 years? In particular, how can we explain Scotland's performance on business research and development, which is more relevant to what you have said so far?

Professor Peat: I have been watching the Scottish economy carefully for 29 years and, the year before that started, I was watching the economy from the Treasury in London, so that is about the same as the period in which you have lived here. Throughout the period from when I was at the Scottish Office to when I was at RBS and subsequently, one continuing issue has been why far more beneficial use has not been made of the remarkably high-quality and high-quantum higher education research and development that takes place in Scotland.

I am not being critical of the universities, because I know that Anton Muscatelli's university and Heriot-Watt University in Edinburgh work hard to use R and D to aid innovation, productivity and competitiveness in Scotland. However, the story of business investment in R and D in Scotland is depressing, relative to the story on higher education R and D, and we need to explore why.

We need to stimulate an environment in which there is greater demand from the business community for innovation and interrelationship with the high-quality academics who undertake that work. We also need to set up incentive mechanisms so that those in universities are as incentivised to use what they produce by way of innovative potential in the business community as they are to produce academic journal articles, which might help in some of the assessments that take place.

I want to see the desire on both sides to innovate and to use the marvellous work that is going on in a number of sectors across Scotland. I am not particularly worried about whether that is in manufacturing or elsewhere, but I believe that there is huge latent potential. Why does that happen in Cambridge but not in Scotland? I do not know the answers to such questions. If we are really interested in Scotland maximising its potential, it is critical that we make use of R and D. We all seek an innovative, productive and competitive Scotland.

Christian Allard: I have a supplementary question. I find it astonishing that we have heard about the banking sector on one side and the oil and gas sector on the other. If we want a new generation of youngsters to get involved in something more productive, should that not be the energy sector more than the banking sector, given what we have seen in the past few years?

Professor Peat: The energy sector has a great deal of potential. We need to see what can evolve from renewable sources and be competitive. We also need to see what the arrangements would be in the event of independence and how energy that is produced in Scotland could be exported to the rest of the UK and elsewhere in order to have external markets.

First, we need to ensure that the renewable sources are genuinely competitive. That takes time to develop, and it requires the right finance to get past the development phase.

The story is difficult. There is potential for production, but whether there is potential for competitive production in the short to medium term raises a lot of questions.

Christian Allard: Like my colleague Margaret McDougall, I am not an economist, but I find it strange that we would explain to the people of Scotland, who are going to vote in September, that the oil and gas sector or the energy sector is somehow a curse, yet the banking sector—despite what has happened in the past few years—is an asset that we are desperate to keep. Will you explain that in words that I can go back to the doorsteps and use to explain that to people?

Professor MacDonald: I used the phrase “resource curse”, so perhaps I should respond. If we do not have oil one day and we discover it the next day, that is great for the overall population, as there is a windfall gain and we are all much better off, but that is not really the point. We are considering how to design an appropriate exchange rate mechanism for a country that we know already has a well-diversified non-oil export sector that involves things from financial services to buses, computers and whatever.

The point is that the shocks that we observe in the oil sector are different from those in non-oil sectors. They are called supply-side shocks. That is the nature of the sector. As we know, the price of oil goes up and down. A key indicator of a country's competitiveness is what we call the terms of trade, which means export prices in terms of import prices. As soon as a country is a net exporter of oil, the numerator in that relationship—the export term—changes. The oil that is bouncing around affects the competitiveness of the non-oil sector. That is a real issue—

Christian Allard: I understand that. I was looking for some simple words.

Professor MacDonald: The concept is quite difficult, but it is an issue for all net exporters. The Gulf states are keen to diversify away from oil, but they find that difficult because of the effect that oil has on their competitiveness and their relative inflation. Their inflation moves differently from that of their competitors. That is the nature of having oil.

Professor Muscatelli: There are two aspects to Christian Allard's question. The first relates to macroeconomics. As Ronnie MacDonald said, and as the fiscal commission recognises, if a country has a volatile element, it needs to manage that, which is why it needs an oil fund or a savings fund.

The second aspect of the question, which is interesting, concerns the industrial structure and economic development. On that subject, I echo what Jeremy Peat said. There is no doubt that it is necessary to address those issues in the long run, because it is too risky for an economy to depend on one or two large sectors such as financial services or oil and gas. One of the key things will be to produce a well-diversified economy that takes account of the high level of skills that Scotland has and the high levels of R and D in higher education, which Jeremy Peat pointed out. However, that is about the composition of spend and where it is directed to. It is nothing to do with overall fiscal and monetary policy.

An interesting study on independence by the Institute for Fiscal Studies compared what small, open economies do and how they direct their spend with what larger economies do. Politicians should be aware of and look at that. Not surprisingly, we find that small economies' spend is directed to things such as economic development and education and away from things such as defence, which are less important to smaller countries than to larger ones. You need to look at such issues.

11:30

Marco Biagi (Edinburgh Central) (SNP): I have a question for Professor Peat. I believe that you said after Mark Carney's "wise pronouncement" that the Scottish and UK Governments should discuss arrangements for a potential currency union. Are you disappointed that the UK Government has ruled that out?

Professor Peat: First, I will make a comment that I should have made in response to the previous question. One concern in relation to the oil and gas sector is that the exchange rate for an independent Scotland might rise sharply. If it rose sharply because of high revenues from oil and gas—because of high prices—that would make it much more difficult for the non-oil and gas sector to be competitive and develop. That is a simple point that I wanted to add.

On Marco Biagi's question, I suppose that I am a bit disappointed. Mark Carney made his comment about two months ago; I thought that it was right and that there should be quiet technical discussions. I have seen comments from Professor Brian Quinn and others about the difficulties of aspects of the currency union proposal and I have read all the material from the National Institute of Economic and Social Research and elsewhere. Obviously, there are complexities. The lender of last resort and the oversight of the banking and financial sector are difficult and problematic, as are issues that are crucial but perhaps more straightforward regarding how to deal with fiscal policy and the management of monetary policy.

I would have liked to see the professionals sitting down with open minds to look at exactly what could be achieved and how we could move to a situation in which the currency union could work in the interests of both parties. The outcome might have been the view that doing that would be extremely difficult and that there would be constraints from the RUK perspective. However, I would have liked to see a professional discussion—it might have taken place behind closed doors—that would have been full, frank and even-handed.

Marco Biagi: At last week's meeting, Crawford Beveridge from the fiscal commission said that the commission had been able to engage reasonably well with the Bank of England but not at all with the UK Government. Do you observe a contrast in that respect as well?

Professor Peat: The discussion should take place first with the Bank of England on a technical basis. Beyond that, the Government needs to be involved. However, the first point is to get down to the technical matters and see what could or could not be achieved, what the tough problems are and whether there is a way forward that might make sense. That is the technical discussion to have with the Bank of England.

The Convener: Sir John Gieve, who is a former deputy governor of the Bank of England, has caught my eye, so I will bring him in.

Sir John Gieve: I am perhaps coming to the defence of my old colleagues in the Treasury. Surely what we need is a degree of certainty on what will and will not be negotiable. It has not surprised me that Treasury officials have said that they would advise against a currency union and that their ministers have said that they agree. I would have thought that that brings some certainty to the debate.

Marco Biagi: I think that the Treasury said in its note that it would disagree to a currency union as currently proposed, which seems quite difficult, as there are no negotiations over the arrangements. However, I will move on to a question for Professor Muscatelli on what he said about the currency zone. Would it be feasible to have the consistent financial regulation that would be needed across the currency zone?

Professor Muscatelli: I think that it would be. Certainly, it is most likely to happen in a currency zone. Some of this has been discussed, but I think that all of us would agree that it is essential to have much better regulatory and supervisory arrangements for the financial sector. We all agree that one of the big failures in the financial crisis concerned regulatory and supervision arrangements. Sir John Gieve highlighted that well.

It would be easier to have such arrangements in a currency zone context. However, if that did not happen and there was a separate currency for Scotland, international arrangements would need to be adhered to.

I certainly think that regulatory and supervision arrangements would need to be part of the negotiation if there were to be a currency area. Anything is possible post the referendum vote, and those arrangements would need to be part of the discussion. There would need to be a single supervisory and regulatory arrangement across the whole financial sector in RUK and Scotland.

Marco Biagi: So you think that that is essentially workable.

Professor Muscatelli: Yes.

The Convener: Thank you very much. We are just slightly behind the clock, so we have all done well. I thank all the witnesses for coming along and helping us out. Their evidence has been useful to the committee.

11:34

Meeting continued in private until 12:31.

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