Independence Options Briefing Note

Currency choices for an Independent Scotland

- An independent Scotland has a range of currency options available, each with its own benefits and risks
- The choice of currency is influenced by the structure of the Scottish economy, its growth potential and its resilience to external economic shocks
- The choice of currency is further complicated by the level of debt an independent Scotland would inherit from the UK

Introduction

If Scotland were to vote for independence in 2014, the choice of currency would affect much more than the notes and coins Scots would use in their everyday lives. The currency adopted by the newly independent state would shape its economy, influence its trading links and play a crucial role in determining how the financial markets view its prospects for growth and the sustainability of public spending.

There are a number of currency options available for an independent Scotland. These range from an agreement with the rest of the UK (rUK) to keep using the Pound Sterling in a formal monetary union, to the issue of a new Scottish currency that could either be tied at a fixed rate to another currency such as Sterling or the Euro, or freely floated on the foreign exchange markets. Each of these options brings its own set of potential risks and benefits. These choices are influenced by the degree of economic and trading integration between Scotland and rUK and are complicated further by the very high levels of debt that the UK has accrued since the financial crash of 2008, which means that a newly independent Scotland would start out with significant debts of its own. Finally, given that the idea of independence envisages a transition to an economy managed to achieve different political objectives to that of the rUK, any currency agreement made at the moment of independence would have to be periodically reviewed as the economies and political priorities of the two countries diverge.

The Scottish Government's currency proposal

In its White Paper on Independence, *Scotland's Future*[1], the Scottish Government (SG) proposes that an independent Scotland will remain in a currency union, sometimes known as a 'Sterling Zone', with the rest of the United Kingdom (rUK). This means that Sterling would continue to be Scotland's currency, and that the Bank of England would operate as an independent central bank for both Scotland and rUK, setting interest rates across the Sterling Zone as a whole. This option was recommended by the SG's Fiscal Commission, which set out the position that retaining Sterling would provide a "strong overarching framework for Scotland post-independence… (and that) a shared currency would be in the interests of the UK given the trade and financial links with Scotland."[2]

This position is largely derived from the theory of 'Optimal Currency Areas' (OCAs)[3]. An Optimal Currency Area is an economic region in which there are clear efficiencies to be had from the use of one rather than two or more currencies. One of the main justifications for the creation of the European Single Currency was that the EU had become sufficiently integrated to function as an effective OCA. Given the level of integration between the Scottish and rUK economies, which are much more deeply integrated than some of the EU economies, the Scottish Government argues that Scotland and the rUK will continue to form an OCA and so proposes that a currency union be maintained between the two countries.

The Fiscal Commission recommended that Sterling should be retained in an independent Scotland in order to ensure macro-economic stability for both Scotland and the rUK following independence. This would be especially important in the early years following independence when Scotland would have to establish its own record of economic competence in the international markets. However, the Commission also pointed out that it is natural for macro-economic frameworks to evolve over time, suggesting that it might be wise to revisit the choice of currency for an independent Scotland after the new state has established its international reputation for sound economic management.

The UK Government has stated its strong opposition to the idea of a Sterling Zone. UK Ministers have argued that they would not wish the Bank of England and indeed the wider rUK economy exposed to the fiscal and other policy decisions of an independent Scottish Government. They and others point to lessons from the Euro zone crisis, especially that for monetary union to work, fiscal policy needs to be very tightly constrained. This is potentially at odds with the Scottish Government's desire to use changes in fiscal policy to boost economic growth, with some commentators arguing that relative changes in competitiveness between an independent Scotland and rUK (in either direction) would lead to an early break up of any Sterling Zone[4].

In theory Sterling is a completely convertible currency that Scotland could choose to adopt without the consent of rUK, but in practice this would be difficult for a variety of economic and political reasons, not least market reaction. Much of the political debate in the referendum campaign to date has therefore focused on the politics of agreeing a Sterling Zone as much as the desirability of a Sterling monetary union in economic terms.

Independence – a clean sheet of paper?

A number of economists do not agree with the Fiscal Commission's advocacy of a Sterling currency union post-independence. Whilst it is clear that retaining Sterling (at least for the medium term) makes sense *politically* since it would make the transition to independence easier for the public, some argue that an independent Scotland needs its own currency if it is to be able to withstand economic shocks, and have greater freedom to set its own macroeconomic policies. Especially important here is that the economy of an independent Scotland would look significantly different to that of the rUK given the much larger relative importance of oil and gas to economic output. In addition, some have argued that the Scottish Government has focused too much on the productivity justification for an Optimum Currency Area, ignoring other criteria such as the importance of asymmetric economic shocks.

Because of this, it is argued that an independent Scotland should approach the question of currency choice differently. With a clean sheet of paper to design a new macroeconomic framework for a newly independent country, commentators such as MacDonald[5], also using the tools of the Optimum Currency Area theory and the classic literature on the choice of fixed versus floating exchange rates, argue that an independent Scotland would be best served by issuing its own currency rather than by retaining Sterling. The value of a Scots Pound could either be determined by floating the currency freely on the world markets, or it could be tied to Sterling, the Euro or a 'basket' of international currencies in order to reduce the uncertainties of a fluctuating exchange rate, in much the same way that Denmark has tied the Krona to the Euro and previously the Deutschmark for many years.

The crucial advantage to be had from a separate currency is that it can be revalued when significant economic shocks affect Scotland or its main trading partners. These shocks could be 'upside' or 'downside' to Scotland, the most obvious example being a significant change in the price of oil. Even an apparently net upside or positive scenario for Scotland, such as a lasting increase in the price of oil to $200 or more or strong, sustained economic growth after independence, could cause important macroeconomic instability. To tackle the problems arising under such a scenario, such as strong inflation, Scotland could revalue its currency to a more appropriate level. However, this would not be possible in a Sterling union or indeed, if Scotland joined another currency union such as the Euro, meaning that the government's room for manoeuvre to deal with inflation (or other economic shocks, such as a recession which affected Scotland more than rUK) would be severely limited. A flexible exchange rate regime, only possible if an independent Scotland has its own currency, acts as a kind of automatic stabiliser in these kinds of conditions, and leaves open the option to devalue, even if as a last resort.

Other economists have argued that the Scottish Government's position on retaining Sterling as an immediate option following independence provides macroeconomic stability, but that thought needs to be given to building those monetary and regulatory institutions which will, in due course, allow Scotland to develop alternative options, such as adopting its own currency.

The debt problem

There are clearly important trade offs to be had between the (medium term) political stability of a continued monetary union and the issuing of a new Scottish currency, and between fixed and floating currency options should an independent Scotland opt for its own money. It could be that Scotland is successful in making a Sterling Zone work for several years or even decades before the accumulation of economic shocks and diverging policy priorities between Scotland and rUK make the creation of a new Scottish currency preferable or essential. Or Scotland might choose to do what most other small countries do and create its own currency fixed to a larger one much sooner following independence.

The situation is further complicated by the levels of debt that an independent Scotland would inherit. The UK's national debt has risen from around £760bn before the financial crash to almost £1400bn in 2012[6]. Even on the most favourable assumptions, an independent Scotland would therefore inherit a very substantial level of debt, debt that would have to be serviced from day one of independence (although the Scottish Government claims that this debt burden at 62% of GDP in 2011 would be relatively smaller than that of the UK at 72%; other commentators estimate higher figures for both Scotland and the UK[7]). In order to convince the international markets of their creditworthiness, small countries such as an independent Scotland need to demonstrate not only that they can repay their debts but also that their currency position is credible, and especially that investors' assets would not be quickly diminished by strong inflation. To avoid the kind of brutal currency speculation that affected the UK and certain other European countries on 'Black Wednesday' in 1992, Scotland would therefore probably have to run small annual current account deficits, or preferably even generate an annual current account surplus. The evidence from other small countries is that they tend to be more fiscally prudent than larger economies because of the need to deal with shocks which affect small open economies.

The cost of servicing the amount of debt Scotland would inherit from the UK makes this more difficult than it might otherwise be. The Scottish Government has focused on the growth potential of the Scottish economy, and argues that the fiscal powers available with independence will increase growth and productivity sufficiently to maintain and improve market credibility, and therefore reduce the debt burden more successfully than the UK has been able to do. However, other commentators have explored different scenarios in which growth does not rise significantly and the 'drag' of debt becomes a significant issue for an independent Scotland. For example, the National Institute for Economic Research (NIESR)[8] has proposed that as part of the independence negotiations, Scotland and the r(UK) should agree an "oil-debt swap" that is that the rUK should share or take over some of Scotland's oil and gas revenues in return for Scotland assuming a lower share of the UK's debt burden. However, as the authors themselves acknowledge, whilst this is perhaps an elegant economic solution, it is probably politically impossible.

Conclusion

Attaining independence is a national statement of intent to change the direction of economic and social policy to address a set of goals and aspirations different to those of the status quo. But any developed country becoming independent would also wish to minimise any disruption that might arise during the transitional phase in order to maintain economic competitiveness and establish the external reputation of the new state.

The debate over the choice of currency for an independent Scotland should be understood in this context. There is a range of views on the 'best' currency option for Scotland, with many economists approaching the question from first principles promoting the idea of a separate Scottish currency. The Scottish Government, with a keen eye on the political landscape of the referendum and the negotiations that would follow a Yes vote, proposes that an independent Scotland maintain a monetary union with the rest of the UK, based on the economic work of its own Fiscal Commission. But as the Commission and the introduction to the Independence White Paper both note, the choice of currency is a political one that may change over time, and may even be forced on an independent Scotland by the financial markets. The choice of currency option for an independent Scotland is therefore a complex one that involves political as well as economic judgements for both the short- and long term.

[1] http://82.113.138.107/00439021.pdf
[2] http://www.scotland.gov.uk/Resource/0041/00414291.pdf, para 2.4-2.5
[3] See http://ner.sagepub.com/content/219/1/F4.full.pdf
[4] See http://www.davidhumeinstitute.com/images/stories/publications/other/Brian_Quinn.pdf
[5] http://repo.sire.ac.uk/bitstream/10943/484/1/SIRE-DP-2013-57.pdf
[6] http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-280528
[7] http://www.scotland.gov.uk/Resource/0041/00418420.pdf

[8] http://www.futureukandscotland.ac.uk/sites/default/files/papers/scotlands_currency_options.pdf