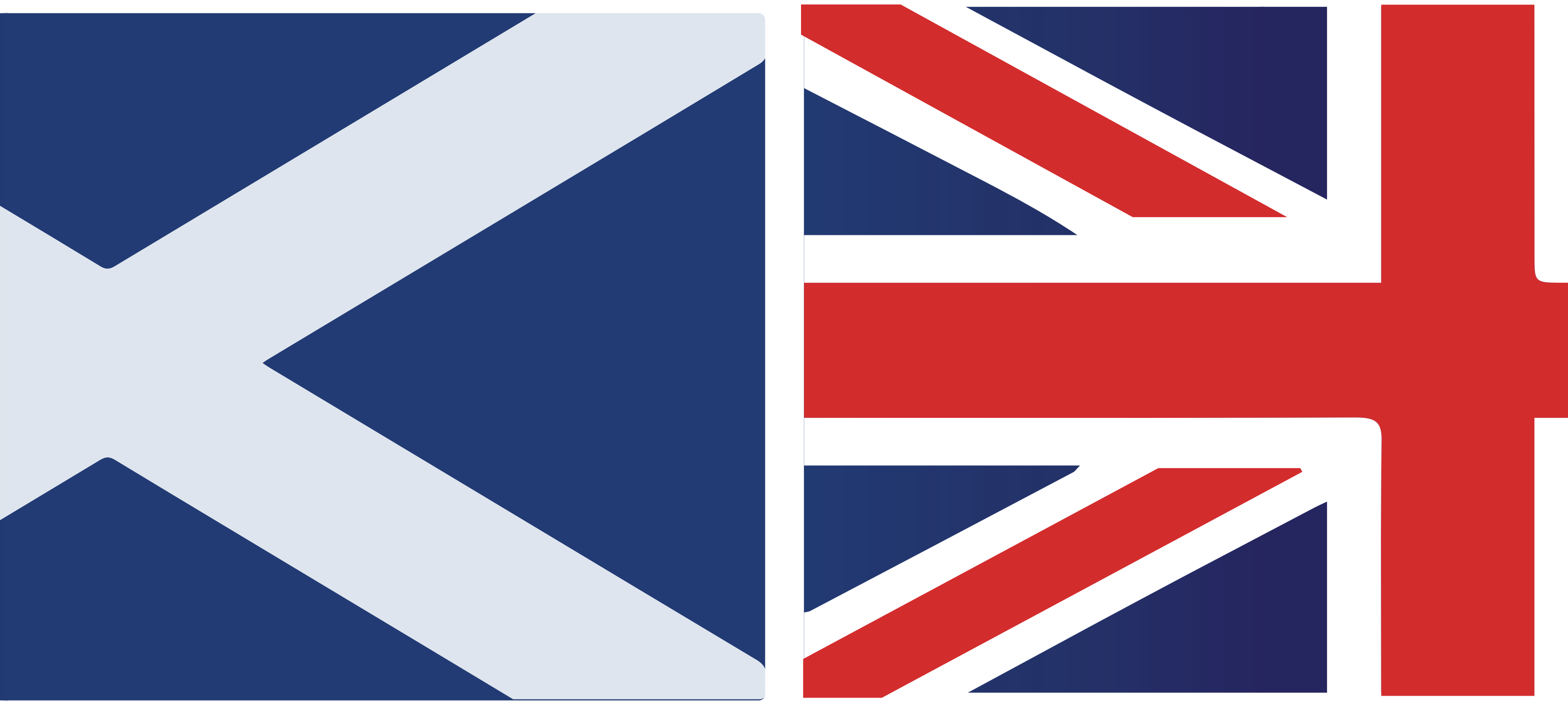
Scottish independence: The currency debate



A World First whitepaper

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Introduction: Does a new country need a new currency?

Wholly independent countries without their own national currency are rare. After all, the essence of independence, so the rationale went, is inherent in the creation of any currency.

However, national pride and the ability to define a nation's identity comes from more than the ability to put a picture of a heroic figure upon the notes and coins.

The advent of digital currencies such as Bitcoin, Litecoin and Dogecoin have seen a new breed of exchange that has become desirable to those looking to be independent of centralised banking, and not bound by national boundaries.

The question of currency and national sovereignty has come to the fore once again this year, as Britain prepares for the possibility that Scotland will leave the Union.

Scotland's decision to put its nation to a vote on independence is a seismic event for the UK as a whole, not just those north of Hadrian's Wall. The structure of any deal needs to be beneficial for all parties concerned; not just the newly independent Scotland nor only for the rest of the UK.

The Scottish government have said to the electorate that should Scotland achieve independence following a 'Yes' vote, that it would like a sterling monetary union handled by the Bank of England as its preferred currency structure. The Treasury, alongside the Bank of England, Liberal Democrats and the Labour Party have rejected this idea out of hand.

A recent YouGov poll put the question to the public, asking "should Scotland become independent, would you support or oppose an independent Scotland continuing to use the pound as their currency?"

The results were fairly conclusive. 64% of Scottish respondents voted "Yes", whilst 58% of those from England and Wales voted "No". This is the definition of a divisive issue.

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Methodology:
Looking at Scotland's options

Scotland, as an independent nation, could choose any currency it wanted to use as its medium of exchange, but for the focus of this whitepaper we will look at the main three choices in question; the British pound, the euro and the new Scottish pound - which for the purposes of this paper we will refer to as 'the Bruce'.

The Scottish National Party's (SNP) preference to hold onto the pound, is no great surprise. GBP is the world's fourth most traded currency, enjoys deep and broad capital markets and is seen, in moments of financial crisis, as a safe haven for investors. It is a trusted asset. It would also seem to make sense from a trade perspective that Scotland keeps the pound – as should the rest of the United Kingdom.

This is where the SNP argument falls down. It makes sense for Scotland to keep the pound from a trade perspective, but not for the rest of the UK. The rest of the UK does four times as much business with the Eurozone and twice as much with US as it does with Scotland. So following that logic the Scots should keep the pound but we should transition to the euro!

The bare faced fact of the matter is that this issue obviously goes a lot further than just trade. Monetary policy is the first and last line of protection for economies when ill winds blow. Using the currency of another without a formal currency arrangement leaves that economy without any formal protections and certainly without any say on policy. That leaves fiscal policy as the loan pressure valve for the economy i.e. the use of taxes and spending to govern economic squalls and the lagging effects of those measures are unable to stave off crisis.

A lack of a currency union means also that there would be no Lender of Last Resort (LoLR) for the Scottish financial sector. They need one. Banking assets as percentage of the country's GDP allow us to measure how over extended the country's financial sector is against the country's ability to help. In 2007, Iceland to all intents and purposes went bankrupt after it let its banks go under in the largest financial collapse in history. At the time of the collapse banking assets as a percentage of GDP was around 800%.

This figure is slightly higher than that of Cyprus (750%) in 2012 before it entered its capital controls in March 2013 in exchange for a EUR10bn bailout from European authorities and the IMF. The figure for a newly independent Scotland would be closer to 1200%. A LoLR is very necessary, but unavailable without a currency arrangement.

The table below shows the options available to Scotland.

Table 1. Summary of an independent Scotland's feasible currency options

Currency	Arrangement	Transaction costs	Monetary policy	Financial stability	Fiscal policy
Scots pound	Fixed/pegged	Highest cost	Central Bank of Scotland	Scotland	No formal limits
	Floating		Central Bank of Scotland	Scotland	No formal limits
Sterling	Informal currency union	None	Bank of England	Scotland	No formal limits
	Monetary union		Bank of England	Shared with UK	Formal limits
Euro	Informal currency union	Medium costs	European Central Bank	Scotland	No formal limits
	Monetary union		European Central Bank	Shared with EU	Formal limits

Transactional costs of exchanging current methods of accounting and tokens of value are large. Denominational changes of mortgages, bills, contracts and signage would need to take place let alone the removal and replacement of the coins and notes in the system. Plus who is to say that 'the Bruce' isn't set upon by world markets at its launch? Currency pegs have been broken before and will be in future.

One thing that would exacerbate this would be the refusal of the new Scottish state to take on its portion of the national debt. UK will have no qualms in pushing Scotland into taking on its share of the national debt in exchange for secession and any hint at refusal would be looked at very dimly by bond markets to which the newly independent country would have to go deal with in the future. What would the electorate say to higher bond yields nationally as a punishment for paying a fair share?

So there are many questions to consider before we can accurately predict what is likely to happen in the event of a 'Yes' vote in September. What follows is a hypothetical and speculative attempt to sketch out what could transpire via three different scenarios; if Scotland keeps the pound, joins the Eurozone or if it creates a new currency – The Scottish 'Bruce'.

Scenario 1: Scotland keeps the pound

In the unlikely event that Scotland votes to leave the union and continued to try to keep the pound then the initial disruption to Scotland would be minimal. Contracts would not have to be renegotiated and transaction costs would remain at zero.

How this would affect the Scottish economy would differ on the way that sterling is held on to. The Scots could go the way of Panama and Montenegro (who use the dollar and euro respectively as their legal tender, without the explicit permission of the issuing authorities) but there will be no representation of Scotland in the creation of monetary policy. Similarly a currency board option, comparable to that operated by the Channel Islands and Isle of Man, would leave the new Scottish state with no say over policy.

The SNP's wish for a Scottish representative on the Bank of England's Monetary Policy Committee is tokenism at its worst - a one vote change out of 10 would have very little impact. They also ask for fiscal independence, but would likely only have one in name should the Bank of England and UK government feel the need to impose budgetary conditions on a new, independent Scotland in the event of a bail-out. If this sounds a lot like the issues we've seen in Europe then that's because they are exactly the same.

This is before the issue of 'moral hazard'; the ability for one party to take risks because the costs of those risks are paid by someone else. An independent Scotland backed by the full faith and credit of the Bank of England is not what the UK taxpayers or politicians will want.

Scenario 2:
Scotland attempts to join the euro

This is not going to happen for one very clear reason. The Maastricht convergence criteria, which countries have to adhere to as a pre-requisite for joining the European Union, contains criteria about having a stable currency as part of the ERM II plan.

In short, you need to have a proven track record of running your own national currency before you can get into the Eurozone.

The ERM II plan is a stepping stone for joining the euro and it requires a currency to remain in the mechanism for no less than two years before it can even be considered for entry into the euro.

Currently the Danish krone, which is pegged to the euro, and Lithuanian litas are the only members of the ERM II plan, and the latter is the only one actually trying to join the euro.

Scotland would need its own currency to join, and proof that the currency was stable before ever attempting the adoption of the euro. A brief flirtation is not enough to convince Brussels that a country is committed to the European single currency.

Scenario 3:
Scotland creates the 'Bruce'

The Scottish 'Bruce' is the most attractive option for those who desire full, unequivocal independence - but this flexibility comes at a cost. Transactional costs would be huge as the entire country is denominated into a new accounting measure, but the government would benefit from a new toolkit of economic levers such as being able to decide, on their own, about exchange and interest rate policy.

An independent central bank of Scotland that wields these powers will also be able to print money in the interest of financial security and stability for its banking sector. Central banks that use other currencies or peg the value of theirs to other currencies cannot run the presses as to create bearer assets to help liquidity issues.

As laid out above, the size of the finance sector in Scotland would need a strong LoLR to make the 'Bruce' work. And the market would certainly attempt to test the resolve of the newly establish Scottish Central Bank.

There would be plenty of difficulties to begin with, but a new Scottish currency may be the best scenario if Scotland does want full, legitimate independence following a 'yes' vote.

Conclusion: The currency question is not something Scotland can control

Currency unions are a good thing in the right context. The Eurozone is the best example of a union that could work perfectly if a couple of major issues were solved. Firstly we must say that nations join the Eurozone currency union in an effort for further integration, not less. Scotland severing some ties but wanting the right to keep the pound is entering a currency union backwards. This is not helped by the Scottish government making it clear in its own independence white paper that “it would, of course, be open to people in Scotland to choose a difference arrangement in the future”. As it’s obvious the deal needs to be sweetened a little further.

Currently the economic pressures being put on the Eurozone are as a result of the split between monetary and fiscal policy. Monetary policy is set centrally by the European Central Bank in Frankfurt while individual governments, unless they’ve taken bailout funding, are free to set their own budgets, taxes and spending. This disconnect, alongside the lack of a banking union, something that the Bank of England Governor reiterated would be necessary at a recent speech in Edinburgh, would kill any currency union before it got off the ground.

Recent political noises have been of how much Scotland is being bullied out of the pound, a currency that is rightfully theirs. Unfortunately the pound is not Scottish, nor is it English or Welsh for that matter, but the currency of the United Kingdom and choosing to leave the United Kingdom involves a choice to leave the pound much like one would not be part of the UK Highways Agency or the UK Border Agency.

Although recent polling has suggested that currency is not a crucial part of the debate, the very essence of what the newly independent Scotland will become is up for debate. While the vote is the decision of the Scottish people, the decision on keeping the pound will ultimately be out of Scotland’s hands. It will be interesting to see whether the reality of this brave new world, and the many structural challenges of forging a new state, will be enough to dissuade Scottish voters away from a breakaway from the UK this September. There’s certainly lot at stake for everyone in Britain.

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