National Institute of Economic and Social Research

Press Release

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Sterling currency zone would not include a Fiscal Compact or Banking Union, and resemble 'dollarization'

New research by Dr A. Armstrong and Dr M. Ebell of NIESR entitled "*Monetary Unions and Fiscal Constraints*", published in the National Institute Economic Review, 228, May 2014

Any negotiation to form a monetary union between two sovereign states substantially different in size, and each acting in their own self-interest, is likely to result in a currency arrangement that resembles 'dollarization' in practice. Contrary to statements from both the UK and Scottish governments, if there were to be negotiations over a monetary union there would be no need for the UK to constrain Scotland's fiscal policy, and no reason for the rest of the UK to accept any such constraint. Moreover, a banking union is unlikely to be sustainable. The likely outcome would therefore be a sterling currency zone without either fiscal constraints or a banking union. This would resemble a 'dollarization' arrangement.

The authors believe that this is the first research to show the very different properties of a monetary union with two sovereign states of such different size, compared to traditional theoretical models which assume several countries of similar size.

This research shows that in a monetary union between two different sized nations there is no incentive for the larger country to impose fiscal constraints on the smaller country. In addition, the larger country knows that the smaller country cannot afford a banking union. Even if a monetary union were agreed to in principle, without fiscal constraints or a banking union this would resemble de facto 'dollarization'. These are general results which apply to monetary unions of two sovereign states of very different size. Armstrong and Ebell apply these insights to the case of Scottish independence, where the rest of the UK is more than ten times the size of independent Scotland by population.

To illustrate these results, the authors assume that the Fiscal Commission Working Group's (FCWG) conception of a monetary union between the rest of the UK and an independent Scotland, with representation in proportion to the relative size of population, is actually agreed. This suggests, for example, that an independent Scotland would have at most one representative on the Monetary Policy Committee, compared to the rest of the UK having eight. It follows that the rest of the UK would dominate every decision and Scotland would have no effective influence on policy.

Therefore, the Scottish government's fiscal or borrowing decisions could not directly influence monetary policy in the sterling area, which removes the rationale for borrowing constraints on an independent Scotland. Scotland might prefer to impose borrowing constraints on the rest of the UK, but there is no reason for the latter to agree. Because constraints on an independent Scotland would be worthless, agreeing to them may invite the perception of culpability and therefore an expectation of a bail-out if necessary. Perception of possible support might undermine the very market discipline which ensures an independent Scotland does not over-borrow.

The FCWG also proposes a banking union between an independent Scotland and the rest of the UK. Armstrong and Ebell show that the banking union is unlikely to be sustainable. In a banking union each country would be expected to make transfers to the other in the event of a banking crisis, in order to assist in the recapitalization of the crisis country's banks. In the event of a banking crisis south of the border, the size of a potential fiscal transfer from Scotland to the rest of the UK might be so large as to outweigh the benefits from remaining in the banking union. An independent Scotland would therefore have no incentive to participate. If the UK understands this participation problem, then it might see the banking union as one-sided to its detriment, and might decline to participate from the outset.

In terms of policy, the report concludes:

- Both HM Treasury and the Scottish Government are incorrect to argue that borrowing constraints would be a necessary requirement for a monetary union. Since an independent Scotland could not effectively influence monetary policy in the rest of the UK, it would have no incentive to over-borrow, which means there is no rationale for fiscal constraints.
- If an independent Scotland cannot influence monetary policy in the rest of the UK (under the FCWG proposal it may have one of nine seats on the Monetary Policy Committee) then there is no guarantee that monetary policy would be appropriate for Scotland. Indeed, Scotland may be best served by mimicking the UK's fiscal policy so its monetary policy is appropriate.
- Because the fiscal constraints on Scotland would be worthless, agreeing to them may invite the perception of culpability by the UK and therefore an expectation of a bail-out if necessary. Perception of possible support might undermine the very market discipline which ensures an independent Scotland does not over-borrow.
- A banking union between an independent Scotland and the rest of the UK is not likely to be sustainable. In the event of a banking crisis south of the border, the size of a potential fiscal transfer from Scotland to the UK might be so large as to outweigh the benefits of being in a banking union. An independent Scotland would therefore have no incentive to participate.
- Since there is no economic rationale for fiscal constraints or a banking union between an independent Scotland and the rest of the UK, any agreements to create them would be seen to be worthless. Indeed, such agreements are more likely to invite perceptions of culpability and an expectation of cross-border bail-outs and therefore undermine market discipline.
- The Bank of England would offer Lender of Last Resort operations to Scottish Banks in the UK conditional on them posting appropriate collateral and at an agreed price. However, if UK tax payers' capital is ever at risk, there is no reason for the Chancellor to agree to extend support to institutions domiciled in a foreign country, including in an independent Scotland.
- Governments which do not issue their own currency can also require Lender of Last Resort operations in extreme market conditions. There is no reason why the rest of the UK via the Bank of England would provide this option to an independent Scotland.
- Without a banking union in a sterling zone, adverse feed-back loops between banking sector risks and sovereign risks may arise. These occur in countries that have high debt burdens and which cannot influence monetary policy. This may encourage Scottish banking institutions to re-domicile in the rest of the UK.
- If banks re-domicile from Scotland to the rest of the UK, this makes participating in a banking union even less (not more) justifiable for an independent Scotland.
- Monetary union without fiscal constraints and a banking union would resemble so-called 'dollarization'. Even if a monetary union was negotiable, 'dollarization' would be a likely outcome of negotiations between two sovereign states of such different size acting in their own self interest. We have shown in previous work that it is doubtful if 'dollarization' with a high level of debt is a sustainable regime.

Quotes

"NIESR's research challenges the conventional wisdom, held by the UK and Scottish Governments, on the desirability of fiscal constraints and a banking union to underpin a monetary union between an independent Scotland and the rest of the UK."

"Monetary union without fiscal constraints and a banking union would resemble so-called 'dollarization'. This would be a deliverable outcome by two sovereign countries negotiating in their self interest, but whether it would be a stable currency regime is an entirely separate question."

"Agreeing to unnecessary fiscal constraints or an unsustainable banking union may invite perceptions of culpability and therefore expectations of a UK bail-out, if necessary. They would undermine the market discipline required to prevent excessive risk taking by an independent Scotland."

"In their earlier research the authors have shown that 'dollarization' in a country with a large public sector debt burden is unlikely to be a stable currency regime."

References

Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, 2013
Armstrong, A and Ebell, M, Scotland's Currency Options, 2013
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Notes for Editors:

1. This press release is based on an article entitled "Monetary Unions and Fiscal Constraints" contained in the National Institute Economic Review, No 228, May 2014. This is a quarterly, peer reviewed, economic and social sciences journal. The full Review is published from midnight on Friday 9 May 2014.
2. This report is part of the National Institute of Economic and Social Research's "Future of the UK and Scotland" work to inform the Scottish referendum debate.
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