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IS THIS PLAN B?

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In the second televised debate with Alastair Darling, Scotland's First Minster, Alex Salmond, made two elements of his plans on currency for an independent Scotland clear. First, he would see a 'Yes' vote as a mandate to press the UK for a formal monetary union, even though that option has already been clearly rejected by the Treasury and the three main political parties. Second, the First Minister threatened to walk away from Scotland's share of the UK public debt if his bid for a formal monetary union is not successful.[1] He has also insisted that Scotland would be able to continue using the pound informally in any event. Comments from advisers suggest this is not just a debating tactic.[2] Sir James Mirrlees, a senior advisor to the Scottish Government, said "it is hard to see how Scotland can take on the debt unless there is a full currency union."[3]

This leads us to believe that adopting Sterling informally while reneging on the debt might, in fact, be the Scottish Government's Plan B. To be clear, we do not know for sure that this is Plan B. But given the Mirrlees and Salmond statements cited above and the total silence on any other option, we suspect that this is at least one of the options being seriously considered. Since Sterlingisation combined with reneging on debt seems to be a serious possibility, we provide an assessment of this currency arrangement.

In earlier research we have argued that Sterlingisation would be a vulnerable currency arrangement given the level of debt an independent Scotland would inherit. We have also argued Scotland would lose a substantial part of its financial services exports which would further undermine the regime. If Sterlingisation is combined repudiating Scotland's fair share of UK debt we expect this regime would fail within a year. Leaving aside that taxpayers in the rest of the UK would each face an additional £5,900 in debt, we believe that this 'opportunistic' behaviour would be seen as a default. As a result Scotland would be outside of the EU and capital markets leading to unprecedented degree of austerity and the eventual a collapse in the currency regime. Scotland would be better off introducing its own currency without losing its foreign exchange reserves first.

1. How much debt would an independent Scotland inherit?

If Scotland becomes an independent nation, it goes without saying that the existing assets and liabilities of the UK state should be divided-up fairly and by negotiation.[4] A few general principles about how to divide up assets and liabilities have emerged. Physical assets tend to be divided on the basis of location, such as infrastructure and, most importantly, oil and gas fields. It would obviously not be efficient to raise and then divide motorways. By contrast, financial assets and liabilities have no fixed location and can easily be shared on some equitable basis such as on a population basis, although other measures have been suggested. We have summarised the Assets and Liabilities which would be divided in various reports.

[1] Alex Salmond reiterated his position that this would not constitute a 'default' on BBC Sunday Politics Scotland on 31st August 2014. The second debate with Alistair Darling had took place on Monday 25th August 2014.

[2] This idea seems to have gained traction in the business community. Martin Gilbert, who runs Aberdeen Asset Management, is reported to have said that "sterlingisation with low or no debt would be a pretty good option."

[3] Reported in the Daily Telegraph, 24th August 2014. A second reading of Sir James's statement shows the importance of having the UK as a financial backstop and perhaps why the UK may be less enthusiastic about a formal monetary union.

[4] Because of the uniqueness of this event, there are few precedents for how to do this. The United Nations 1983 Vienna Convention only states an 'equitable' distribution and has not even been ratified by an OECD country and has no basis in law.

In Table 1 we show the debt burdens of both an independent Scotland and the rest of the UK assuming that the debt is divided on a population basis and that an independent Scotland is allocated a 'geographic' share of the North Sea oil and gas reserves. We show both commonly used debt measures, public sector net debt (PSND) and the international standard gross or Maastricht debt definition.[5]

Table 1: Hypothetical debt burdens in 2015 /16 (end of period)

	Total Debt	Independent Scotland		Rest of UK	
		£bn	% GDP	£bn	% GDP
PSND	1,439	119.6	72.7%	1,439	88.5%
Gross Debt	1,667	138.5	84.2%	1,667	102.5%

Source: OBR (2014), GERS (2014) and NIESR estimates

Three points are worth noting. First, the debt burden of the rest of the UK would be higher than for an independent Scotland. This is because Scotland does not have the spare cash to immediately repay the rest of the UK, so the UK would become a sovereign lender to Scotland instead. Since Scotland's IOU to the rest of the UK would not constitute a 'liquid asset', and the UK loses Scotland's GDP, both the gross and net debt burden rise. Second, both nations would have gross debt burdens much higher than the Maastricht maximum of 60%. Third, as we said at the start of the year, the UK debt burden is likely to attract the attention of credit rating agencies.

We have discussed on many occasions how Scotland will repay its fair share of the existing debt. The Scottish Government proposes repaying the debt on the basis of the maturity of the UK debt where the average maturity is about 15 years.[6] The Treasury (2014b) suggest a far more lenient approach of repaying 5% of the outstanding stock per year. Of course there would be interest on the outstanding debt, although the rate of interest which Scotland would be charged would no doubt be part of a negotiation. In section 6 we assume for simplicity that Scotland's share of UK debt is settled at £120bn after some asset sales (military) and that this is repaid at 5% per year in line with the Treasury's working assumption.

2. Which Bank of England 'financial assets'?

The idea of not accepting a fair share of existing UK debt is tied to the UK's rejection of a formal Sterling monetary union which would require sharing the Bank of England. In recent weeks the statement that Scotland would only take a fair share of liabilities in return for 'a fair share of assets' has been replaced with 'a fair share of financial assets'. This is puzzling because the government's financial liabilities are more than its financial assets. Perhaps what is really meant are the financial assets of the Bank of England. The balance sheet of the Bank of England is £405bn and by far the biggest asset is the loan to the Asset Purchase Facility to fund the purchase of £365bn of gilts (Quantitative Easing assets).[7] But this loan is in turn funded by the deposits of private banks (bank reserves, a liability on the Bank's balance sheet). So taking on ownership of some of the APF gilts would require taking on the

[5] The PSND is the total issued financial liabilities (gilts and National Savings and Investment debt) minus liquid financial assets (foreign exchange reserves and cash deposits). Gross Debt is the more commonly used measure (also called the Maastricht definition of debt) which does not allow for the netting-off of liquid assets or the exclusion of debt by other public bodies and so can be considered a more accurate indication of state debt.
[6] Scottish Government 2013a, p349.
[7] The Bank of England is only the Treasury's agent for managing the foreign exchange reserves.

corresponding liability to banks, otherwise the Bank would be insolvent. An independent Scotland might expect a fair share of the net worth of the Bank (i.e. total assets minus total liabilities) only worth around £250mn.[8]

Perhaps 'financial assets' refers to the Bank's backing of Sterling. However, since 1931 Sterling has not been backed by gold, but by Parliament's commitment to use its (future) taxation powers to meet its obligations. It is a fiat currency. Sterling is therefore a claim on the (future) income of UK citizens. This is where its value comes from. Since Charles II the UK Parliament has always honoured that commitment. It is simply not possible to transfer that reputation to a newly founded state such as an independent Scotland. It also explains why allowing another state to even partly control the supply of sterling, the size of the claim on UK taxpayers, is a very unlikely proposition. If a country does not control the supply of currency, it cannot be called its 'own currency' in any meaningful sense.

3. Would non payment of debt be a default?

Suppose an independent Scotland refused to accept what is widely seen as a 'fair share' of the existing UK debt, would this constitute a default? Technically, it would not, because the debt was issued by the UK government, not by Scotland, and the Treasury has stated that "the continuing UK Government would in all circumstances honour the contractual terms of the debt issued by the UK Government." [9] However, the Treasury also states that "an independent Scotland would need to raise funds in order to reimburse the continuing UK of its share." Not taking on its fair share of the UK debt – debt that was incurred to build roads, hospitals and schools throughout the UK – would be a refusal by Scotland to meet its financial obligations.

The reason for reneging on debt is also important. Some debt created by particularly unpleasant governments without the consent of the people is called 'odious' and sometimes forgiven. Sometimes debt obligations are so big that it is impossible to see how they can ever be repaid and it may be efficient to 'wipe the slate clean'. Some Southern European states are arguing that the amount of debt they assumed during the crisis was beyond their control and is therefore illegitimate. Any claim by the Scottish government that its debts are 'odious' or illegitimate would be likely to be met with stiff resistance by northern European creditor countries who have been insisting that southern European countries repay their debts. It is also difficult to argue that Scotland – with its higher level of public spending per capita – has been so hard done by the UK as to not accept to repay its debts.

If Scotland refused to repay the UK for its fair share of debt how would this interpreted? Clearly the debt cannot be considered 'odious' or 'illegitimate'. Neither can it be argued that Scotland would be doing this because it is impossible to repay the debt. It would simply be because the UK chooses not to enter into a formal monetary union. Moreover, a proportion of the UK debt is of course held by Scottish adults in their pension assets. If an independent Scotland refused to pay its share fair share this would simply add on average up to £5,300 to the debt of all taxpayers in the rest of the UK who have no say in the referendum. We are not convinced that fair minded Scots or citizens of the rest of the UK would accept this as reasonable. While this may technically not be a default, it strikes us as 'opportunistic' and therefore is likely to be interpreted as a default.

4. Sovereign borrowing costs and market access

In our paper on Scotland's Currency Options we estimated what borrowing costs for an independent Scotland would be relative to UK borrowing costs. We estimated that Scotland would pay between 0.72 and 1.65 percentage points more than the UK to borrow at a maturity of ten years. To put this into context, using the mid-point of the estimated range, this means around £1.7bn more in interest payments per year. This equates to the

[8] The Bank of England's 2014 balance sheet shows equity funds of £3,047mn.
[9] HM Treasury (2014a)

2014-15 budget for the Scottish Funding Council, which is responsible for funding all of Scotland's universities and colleges. Our estimates have been used by almost all third party industry experts and we are unaware of any comparable estimate. We have had one challenge from Professor Hughes-Hallett who noted that we had omitted currency risk. This was intended and we replied here.[10]

If Scotland were to renege on its fair share of UK debt, Scotland could expect its borrowing costs to be even higher. In addition to the liquidity and macro variables, an additional sovereign risk premium would be required. The closest parallel is Ireland defaulting on its land bond annuity payments to the UK in 1932. Foley-Fisher and McLaughlin (2014) show that the spread in borrowing costs between Irish and UK land bonds widened significantly after the Irish default (or refusal to transfer the interest payments to the UK). The higher borrowing costs (perhaps 60bps) persisted for many years. The authors conclude that "uncertainty about fiscal responsibility may raise the cost of borrowing for many years after succession occurs."[11]

How much higher would an independent Scotland's borrowing costs be? A Moody's report showed that in three out of four cases of a country 'break-up' there was a sovereign default. If Scotland were not to pay its fair share of debt, we fully expect that it would have a junk rating status. While there have been 30 sovereign defaults since 1997 none of them resembles Scotland and so the impact on bond yields is probably of little guidance. The most important lesson from the sovereign debt default literature is not the higher borrowing costs, which are very much specific to each event. Moody's reports that those states which default cannot borrow for an average period of 5.6 years up to final resolution and then 4.4 years afterwards. In other words, 10 years out of the market. This finding is supported by academic research using the largest database of sovereign country defaults. Markets indeed eventually 'forgive and forget' but this tends to be many years after the event. Scotland is unlikely to be excluded from markets for so long, but there is no free lunch from an opportunistic default.

5. European isolation?

If Scotland were to refuse to take on its fair share of the UK's debt, this might jeopardize Scotland's entry into international institutions, including the European Union. We have always assumed in our work that Scotland would join the EU at the earliest opportunity, but this was on the basis of independence being purely an internal UK affair. If Scotland reneges on its debt, this would no longer only be an internal UK issue. If the EU were to admit a country – any country – which had just seceded and walked away from its debts, it would be creating an extraordinary precedent with potentially far reaching consequences. Many EU countries are heavily indebted, and many regions in the EU have long harboured separatist sentiment. Spain is heavily indebted, and would face serious questions about its solvency if two of its richest regions, Catalonia and the Basque Country, were to walk away from both the Spanish state and its debts. Italy is facing debts of more than 100% of GDP and might find itself in a similar position. Belgium, also facing debts in excess of 100% of GDP, would have grave concerns about a Flemish bid for independence.

But in Realpolitik terms, the highest hurdle for any Scottish bid for EU entry would be obtaining Germany's 'yes'. Germany is the main creditor nation, the most economically powerful country in the EU. What are its interests? The stability and solvency of Germany's own financial system relies on the repayment of sovereign debt owed to its banks by Greece and other southern European countries. If Scotland were allowed to set a precedent for EU

[10] This is a bizarre suggestion since we took the whole point of a formal currency union to be removing the currency risk.
[11] Foley-Fischer and McLaughlin (2014) p24.

membership after secession, despite debt repudiation, Germany would be highly exposed to any other ensuing post-secession insolvencies. Germany would be among those hardest hit if Spain or Italy were to find themselves unable to shoulder their existing debt burdens after the breakaway of their richest regions.

Moreover, if Germany were to welcome a Scotland that has just refused to pay its debts into the EU fold, it would open itself to the charge that it was giving unequal treatment to Greece and Scotland. Greece might well feel emboldened to abandon its efforts at austerity and default on (more of) its debts, without fear of any (broadly defined) sanctions. This might in turn set off a 'domino effect' of defaults from other southern European countries. While the secessionist domino effect from Catalan or Basque independence might be a more medium term risk, as independence movements take time, the risk of such a Greek domino effect might be more immediate.

6. Internal and external funding requirements

The outlook for the balance of payments is key to whether any fixed exchange rate is sustainable.[12] Periodic deficits on the balance of payments can be met by running down foreign exchange reserves, assuming there is a large enough stockpile to begin with. But if deficits are likely to be persistent, then investors will seek to avoid being left holding assets in a country which may need to introduce its own currency. This act of avoiding an exchange rate loss is capital flight, which can turn the feared devaluation into a self-fulfilling prophecy. The question then becomes whether there is the political will to defend the exchange rate by accepting high unemployment and lower incomes to regain competitiveness and transform the balance of payments back into surplus (so-called 'internal devaluation') and by mobilising sufficient international support to backstop this transition. If the electorate considers that the costs of defending 'sterlingisation' are too high then a new exchange rate regime is introduced, but almost always after all of the reserves have been lost.

The IMF approach to making judgements about currency sustainability is to estimate an external financing requirement. This is particularly difficult for Scotland because, as part of the UK, there are no official fiscal or external accounts. We can only make informed guesses based on available information. Table 2 puts together data from various sources to illustrate an independent Scotland's external financing position.[13] The onshore and offshore fiscal figures for 2013 are from the Scottish Government and for 2016 are from Fiscal Studies Scotland.[14] To be conservative we assume that after some horse trading over assets, an independent Scotland would have an IOU to the UK of £120bn which is repaid at 5% per year. We also assume that the interest rate charged on the remaining debt is the same as the UK interest rate (so the pro-rata interest payments are already included in the deficit figure). In 2016 an independent Scotland would need to issue over £17bn of debt even on these generous assumptions. Given that no domestic capital market even exists at this point, this is a tall task.[15]

There is much less data on external funding. According to the Scottish Government's experimental data, the trade balance for 2013 including oil and gas sales from a geographic share of the reserves would be a surplus of 1.9% of GDP. Without oil and gas exports the deficit would be 8% of GDP. To find the current account we need to add net factor income and any transfers. The Government has published an estimate of net factor income for 2010 only which showed a deficit of £7.4bn. Some £5.4bn was associated with the oil and gas industry. To be conservative we have included a figure of half this amount in 2013 as oil output was significantly lower. There is no estimate of

[12] Sterlingisation – or continuing to use the pound informally – is in essence a fixed exchange rate.
[13] The internal funding figures are for financial year (i.e. 2013 is the financial year 2012-13).
[14] The Fiscal Studies Scotland figures are more optimistic than Moody's and other forecasters.
[15] We assume that the interest rate charged on the IOU to the rest of the UK is the same as the interest rate the UK pays. This would be a subsidy from the rest of the UK.

transfers, but for the UK the figure was an outflow of £5.4bn so a population share would be £0.4bn. As we have stated before, we believe that the current account was at best zero in 2013 (although more likely a small deficit as we have shown in Table 2).

Looking ahead to 2016, if the external account figures were the same (and this involves some best guess judgements) and the debt repayment schedule is adhered to, then the current account deficit might be around £7bn. This is the same amount as a population share of the UK's existing foreign exchange reserves. Note that this assumes that Scotland maintains the same level of exports of financial services. Given that the major banks have signalled their intention to shift some business into the rest of the UK, this is almost certain to be too optimistic. To find the balance of payments the international capital flows are added to the current account. As long as there is at least the prospect of Scotland running out of reserves and being forced to introduce a new currency in response there is more likely to be capital outflows than inflows.

If Scotland reneged on its debt there would not be the £6bn transfer, but then presumably the rest of the UK may think twice about handing over a share of the foreign exchange reserves.[16] Even if the UK continued to share its foreign reserves, after an 'opportunistic' default private capital is more likely to leave than enter Scotland given the risk to further financial opportunism and the diminishing prospects of EU entry. We expect that capital markets would effectively be closed to the Scottish Government for some time meaning that Scotland would have to change is fiscal deficit into a surplus immediately. This would bring an unprecedented degree of austerity.

Table 2: Independent Scotland's funding requirements

	2013[17]		2016	
	£bn	% GDP	£bn	% GDP
Internal funding				
Onshore fiscal deficit	-17.6	-14.0	-14.7	-10.1
Fiscal deficit incl. oil and gas	-12.1	-8.3	-11.3	-6.9
Debt repayment	Na	Na	-6.0	-3.6
Debt issuance	Na	Na	-17.3	-10.5
External funding				
Trade balance incl. oil and gas	2.7	1.9	Na	Na
Net factor income	- 3.7*	-2.5	Na	Na
Transfers	Na	Na	-0.4	-0.25
Debt repayment	Na	Na	-6.0	-3.6
Current account	-1.0	-0.7	Na	Na
Memo: CA ex 25% financial exports	-4.8	-3.2%	Na	Na

Note: oil and gas is allocated on a geographic basis. The net factor income is based on a Scottish Government study using 2010 data. Souces: Scottish Government (2014), Centre for Public Policy Regions (2014), Scottish Government (2013b), HM Treasury (2014b) and NIESR estimates.

7. Assessment

In 2016, Scotland is likely to face twin deficits in the year that it might become an independent nation. These deficits are substantial: a fiscal deficit of over 6% of GDP and an external deficit, although difficult very to judge,

[16] Armstrong and McCarthy (2014), p. 14.
[17] The fiscal data in 2013 refers to FY2012-13.

may be similar in magnitude. This includes a geographic share of North Sea oil and gas reserves. An independent Scotland would inherit perhaps £7bn of foreign exchange reserves. Claims that there are other financial assets, specifically quantitative easing assets, to be shared miss the fact that these are fully funded by financial liabilities. We estimate that an independent Scotland is likely to inherit between £140bn and £120bn of the existing UK debt. Even assuming 5% repayment per year, an independent Scotland would face a funding requirement of at least £17bn in the first year. 'Sterlingisation' is likely to be vulnerable to even a modest negative shock.

If the Scottish Government combines 'Sterlingisation' with reneging on its fair share of UK debt, which judging from the First Minister's comments may be Plan B, this would increase rather than reduce the fragility of the currency arrangement. The 'appeal' of this option might be that it reduces the internal and external funding requirements. However, this would be a false economy. International investors are likely to see walking away from debt as 'opportunistic' and either charge very high borrowing premiums or exclude Scotland from international markets. This would imply an immediate return to a fiscal surplus and therefore unprecedented austerity. Entry into the EU would be out of the UK's hands, even if it supported Scotland's case. This would raise doubts about the outlook for exports, particularly for financial services. Whether the citizens of Scotland would accept this policy simply to hold onto sterling would become a source of speculation with a low level of reserves as defence. We would expect the currency arrangement to fail and Scotland would be forced to introduce its own new currency within one year.

Introducing a new Scottish currency has always been the most sensible option. We would recommend this is carried out before losing £7bn of foreign exchange reserves rather than after.

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