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SCOTLAND'S 'HARD' CURRENCY OPTIONS

Introduction

Good evening ladies and gentlemen. It is a great honour to speak at the launch of **Policy Scotland**. This is an auspicious time to launch a new public policy institute. In only fifteen months, there will be a referendum which could see Scotland regaining independence after more than three centuries. If Scotland chooses to remain part of the United Kingdom, there is also good chance of further constitutional reform.

Policy Scotland can play a vital role in informing citizens about the truths and untruths in these debates. With so much of the old policy order open to question, the launch of **Policy Scotland** is timely and very much needed.

I am fortunate to work for the UK's oldest non-university economic research institute. In my view the essential ingredient for **Policy Scotland** is that its independence is always seen as beyond doubt. I hope **Policy Scotland** is also prepared to take risks. It was Keynes who said that "words ought to be a little wild, for they are the assault of thoughts on the unthinking."

I hope my remarks tonight are in this spirit. After all, politicians will not be the arbiters of whether a currency regime stands the test of time. Professor Michael Dooley captured this perfectly in saying that "monetary regimes have been born at a conference table and laid to rest in foreign exchange markets."[2] It is private investors' incentives based on economics rather than the wishes of politicians which will eventually prevail.

The key point I wish to make this evening is that if an independent Scotland is to prosper, it requires a 'hard' currency. What do economists mean by a 'hard' currency? At a minimum, a 'hard'

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[2] Michael Dooley, 'Speculative attacks on a monetary union?' International Journal of Finance and Economics, vol.3 21-26, 1998.

currency enables the development of a domestic long term debt market. It therefore requires that government solvency is almost beyond doubt.

My remarks this evening are in three parts. First, I will cover some preliminaries on the division of assets and liabilities between an independent Scotland and the UK. Then, I will discuss Plan A – the Scottish Government's preferred option of forming a currency union with the UK. Finally, I will discuss a gradually emerging Plan B – the viability of re-introducing a Scottish currency.

A. The division of assets and liabilities

First some preliminaries on the division of assets and liabilities. If Scotland becomes an independent nation, the assets and liabilities of the existing UK would be divided between the successor UK and Scotland. The major assets are the oil and gas fields and state offices, and the major liability is the outstanding amount of UK public sector debt. Oil experts suggest that the oil and gas fields will be divided according the median line. If this is correct, this would mean that Scotland would get approximately 90% of the remaining reserves.

With regard to the public sector debt, it is important to appreciate the size of the problem. A member of the Parliamentary Commission on Banking Standards last week said that the impact of the banking crisis on state finances has been similar to a major war. Usually when we take on a huge amount of debt we have some new assets to show for it - not in this case.

According to the Office of Budget Responsibility, the UK public sector net debt will exceed £1.5 trillion at the time Scotland would become independent. There will of course be a negotiation on how this debt should be shared. If the debt is divided on a population basis, an independent Scotland is likely to start with over £130bn of debt.[3] This does not include future public sector liabilities (such as state pensions) or contingent liabilities (such as bank deposit insurance).

The next task is to negotiate how to transfer the agreed share of public debt to Scotland. The technicalities involved are under-estimated. Scotland does not have a spare £130bn and the UK is unlikely to be keen for an IOU from a foreign country which would surely impact its credit rating. The UK government seems unwilling to say how it considers the debt should be divided or how this would happen in practice. Leaving this until after the referendum is a risky strategy and not conducive to an informed debate.

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[3] The Office of Budget Responsibility estimates the public sector net debt will be £1,580bn in 2016-17 (when independence would occur) and Scotland's population is approximately 8.4% of the UK total.

B. Is a monetary union possible?

If sovereignty is to have meaning in a monetary union there must be some spheres of economic management where that nation determines its own fate. Determining one's own fate also means there is at least the possibility of failure, or in this context sovereign default. If default within the union is not at least a possibility, then the nation is too big to fail within the union. This creates the same distortions to incentives as we have seen in the banking sector. This would obstruct the fiscal discipline independence is supposed to create.

For the monetary union to be stable, default must at least be possible but without creating the incentive to leave the monetary union. In other words, the benefits of remaining in the union must be greater than the costs; otherwise private investors will begin to shift their money out of the country thereby deepening the crisis.

The classic example is the states in the United States which have a high degree of fiscal sovereignty. States have failed in the past and some more recently have been close to the brink. To compensate investors for the risk of default state debt often carries a high yield. Yet the risk of default does not lead depositors to shift savings into other states or create the expectation that the state would leave the union. The financial system is protected by the Federal Reserve and would function as before any default. Because this is a national monetary union with critical services provided at a Federal level there is little incentive for capital flight.

If a nation can at least, in theory, become insolvent, without changing the political calculus in favour of leaving a monetary union, then at least some of the economic functions must be shared with other nations in the union. The challenging question is who would provide liquidity services to financial institutions in an independent Scotland. As we have seen, a newly independent Scotland is likely to inherit a high level of public debt and so its capacity for support will be limited.

The Bank of England is constituted under the UK Parliament, and so any such services it provides must be in the interests of UK taxpayers.[4] It is unclear that the Bank would provide lender of last resort services directly to Scottish based institutions in Scotland in the event of independence. This would essentially be providing liquidity services to an offshore sterling financial centre. In rare circumstances exceptional liquidity assistance is provided to institutions thought to be solvent but known to be at risk. This requires the agreement of the Treasury as UK tax payers ultimately bear the cost of failure. It is difficult to see how this service would be extended to what would be a foreign

[4] There are other models such as used in the Crown Dependencies (Jersey, Guernsey and the Isle of Man) but this does not involve the provision of liquidity services.

country. There is no precedent for tax payers in one country underwriting the banking services of a separate country.

Finding an answer to this problem is a necessary condition for creating a stable multi-national monetary union. There would need to be a legal agreement between the UK and Scottish Government to apportion any losses which arise in an independent Scotland to Scottish taxpayers. This would be particularly difficult agreement to construct. It is extremely difficult to know even in the broadest terms how the future losses may occur in two or three or more decades' time when the present crisis is almost forgotten.

More substantively, how would this agreement would be enforced? To be sure that either country could pay for its losses, this would require possibly intrusive fiscal controls and limits. The very time that the agreement would be invoked (during a banking crisis) is when a government would be least able to afford to pay. There are few cross-border bi-lateral agreements where legal enforcement can be assured. Indeed, the paradox is that to ensure that another party can always pay, there must be enough fiscal limits to make sure that the possibility of failure can never occur. This of course undermines the fiscal discipline that independence is supposed to create.

Professor Otmar Issing, former chief economist of the Bundesbank and European Central Bank has said that "there is no example in history of a lasting monetary union that was not linked to once state."[5]

C. Re-introducing a Scottish currency

Let me now consider the gradually emerging Plan B – re-introducing a separate Scottish currency. Let me start by reviewing some of the mechanics of re-denominating a currency. An independent Scotland would have to move swiftly to create the necessary institutions and capital markets. This would include a central bank, a payments system, deposit insurance, prudential and conduct financial regulators, a debt management office, an exchequer, a tax collection agency, a fiscal commission, equity and capital markets and, of course, a currency mint.

There would also be many technical issues to solve. The Scottish Government would presumably pass a redenomination law to introduce the new currency. This would require wages, pensions and procurement in Scotland to be redenominated. Debt contracts such as mortgages and company loans under Scots Law would be converted and, to avoid financial imbalances, even some

[5] Quoted in Mayer (2012), "Europe's unfinished currency" Anthem Press.

deposits may need to be converted.[6] Professor Barry Eichengreen's review of the Argentine experience is that it is better to go the whole hog rather than piece-meal.[7]

So what makes a currency ‘hard’? So far the definition of a ‘hard’ currency has been unhelpfully circular: a ‘hard’ currency requires a long term debt market which in turn requires a ‘hard’ currency. Ultimately, a 'hard' currency is one where the creditor is likely to receive full payment. This likelihood will be some function of macroeconomic conditions, political predictability and a history of honouring payments built up over the long term.

Necessary economic conditions include at least the following three factors. First, a history of low and stable inflation; this will prevent currency losses for foreign investors and an erosion of real returns for domestic investors. Second, strong productivity growth in the non-oil sector of the economy to increase competitiveness in the long term and a good real rate of return for investors. And third, low levels of debt and relatively high levels of reserves just to be ready for the inevitable periods of economic turmoil which happen to all countries. If all these conditions are met, then there is a chance that the sovereign would be expected to be always solvent and the currency would come to be seen as a ‘hard’ currency in time.

What exchange rate arrangement would have the best chance of achieving these economic conditions? The Scottish government would have the choice of whether to have a fixed exchange rate (presumably to sterling) or floating exchange rate or somewhere on the spectrum between the two. A fixed exchange rate (if it is credible) would minimise the cost of hedging currency risk and bring the advantages of greater price transparency (easier to compare price). In theory, the closer to a floating exchange rate the more flexibility Scotland would have in setting monetary policy.

If the new Scottish currency could be successfully fixed to sterling, this would remove most of the exchange rate uncertainty. For a small open economy, this would also be the best way of signal to investors an intention of keeping inflation low and stable. Essentially this would be using the anti-inflation credentials of the Bank of England.

There would invariably also be costs. This would remove any tools of monetary policy from the Scottish central bank. While the Scottish and UK economies have been similar in the past, after independence they would look quite different. Most importantly, Scotland would be a net exporter

[6] Not all contracts will be between parties in Scotland, under Scots Law or specify a Scottish court as arbiter. Presumably many corporate transactions are in English Law. In such cases, redenomination could become contested.
[7] Eichengreen, (2007), The Breakup of the Euro Area, mimeo

and the UK a net importer of oil. Large swings in the oil price would therefore have quite different effects on both economies and require different policy responses. If the large swings in oil prices could not, to some degree, be mitigated by similar movements in the exchange rate there is a risk that this would create competitiveness problems in the non-oil sector of the economy.

Is a fixed exchange rate possible? An independent Scotland would inherit foreign exchange reserves of around $10bn – too small to support or defend even a moderate currency attack. To accumulate reserves Scotland would need to run steady balance of payments surpluses. At this point, it has to be said that we know very little about the position of Scotland's external accounts. The Scottish Government's experimental national accounts data currently uses a residual balancing which suggests a small deficit, although there is great uncertainty.

E. Using oil to repay debt

If an independent Scotland is to re-introduce a hard currency then foreign investors must expect that solvency is virtually assured. One way to achieve this is to run large fiscal surpluses which would inevitably depress domestic demand and so lead to current account and balance of payments surpluses. Some of Europe's weakest economies are now running, or close to running, current account surpluses. However, because Scotland would start with a high debt to output ratio, depressing demand might raise the debt burden (as a share of GDP), as has happened for the UK.

An alternative idea would be for an independent Scotland to commit to using the tax receipts from the North Sea to repay the inherited national debt. If the interest rate of Scottish debt is higher than could be guaranteed through investments then this, rather than a sovereign wealth fund, would be the prudent course of action anyway.

The argument is based on optimal risk sharing. An independent Scotland would have to issue government bonds at long dated maturities at a time when many governments will be borrowing large amounts. The UK government already has a long dated yield curve. Scotland's government finances would be highly sensitive to the oil price. For example, the Government Expenditure and Revenue Scotland 2013 report shows a separate Scotland net fiscal deficit without oil of 14.6% of GDP and with a geographic share of oil of 5.0% for 2011-12. If Scotland were to exchange the North Sea oil for reducing the debt there are two benefits: first, they would inherit a much lower share of debt, and second, the difficulty of managing such a volatile but large income stream would be transferred to a country where the volatility would be less problematic.

In keeping with my opening comments to be a 'little wild', if this could be negotiated, an independent Scotland would start as a relatively low debt sovereign country and without the

volatility associated with swings in the oil price to manage. This would be a starting point for developing a 'hard' currency. Of course the oil tax revenues would no longer exist. Since the future revenues would repay the national debt, they could not be used in a sovereign wealth fund or to pay for public spending. The money can only be spent once. The government would also have to run a tight fiscal policy for a significant period of time. Reducing the 14.6% fiscal deficit would be quite some challenge. However, this at least would form the basis for achieving a 'hard' currency status. Whether this would prove worthwhile depends on many factors, not least the implicit price for oil assumed in the debt exchange.

Conclusion

If all of this sounds like a very difficult set of choices then I have done my job. A prosperous Scotland requires a 'hard' currency. If Scotland is to re-introduce its own currency, the solvency of the government must be almost beyond doubt. How this is achieved will require very difficult policy choices with enormous welfare and implications. That is why it is so important to have institutions like **Policy Scotland;** to think alternative ideas, develop feasible policy options and examine and explain the trade-offs they involve.

Thank you.

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