SCOTLAND'S POSSIBLE CURRENCY OPTIONS

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In the Scottish Government's White Paper, the First Minister states "at its heart...independence...is about the power to build a country which reflects our priorities as a society and our values as a people."[1]

So the issue this evening is – which currency arrangement would best allow these different priorities and values to be expressed?

The Scottish Government has made it clear that in its view, a full-blown monetary union with the rest of the UK would be best for an independent Scotland and the rest of the UK.

Just to be clear on terms; Currency Unions or a Sterling Zone can take many forms, but the White Paper refers to formal Monetary Union, which means a shared central bank, monetary and financial policy and the same currency.

So a good place to start is asking, "What's in it for each side?"

Why might an independent Scotland benefit from a Sterling Monetary Union?

On the surface, it seems to have the advantages of continuity and minimum disruption: people receive their wages and pay their mortgages in Sterling. The government would issue debt in a world currency and there would be no costs to cross-border trade with the UK.

All of this could be achieved in a Currency Union rather than Monetary Union.

But the Monetary Union also comes with an implicit insurance policy, and a policy without any premiums, just in case Scotland (or its institutions) needs emergency financial support.

Europe has shown how – for all the cast-iron "no bail-out" clauses in international Treaties – they are simply over-ridden when needs must.

The Bank of England would carry out the policy, but it would be the rest of the UK taxpayers who would be the main underwriters.

What might the rest of the UK get in return?

The rest of the UK also avoids the exchange costs in trade with Scotland.

The rest of the UK avoids losing the lion's share of oil and gas exports, which account for about 7% of total UK exports.

But because the UK would be 10 times bigger than an independent Scotland, it's pretty inconceivable that Scotland could ever bail-out the rest of the UK.

Now, if both sides gain, albeit unequally, what is the problem with a Monetary Union?

First, as with all insurance policies, it creates an incentive to take more risk. The UK would presumably want fiscal constraints to prevent an independent Scotland responding to these incentives.

Second, the more debt Scotland inherits, the higher the risk and the bigger the possible insurance claim, the tougher the constraints. And if Scotland chose not to take a fair share of the debt, would the UK even consider a Monetary Union?

Third, sovereignty means that any government is free to withdraw whenever it chooses. The White Paper makes this clear "*it would be open to people in Scotland to choose a different arrangement in future*."[2]

So what might this Monetary Union look, like and would it fulfil the aspirations of an independent Scotland?

(1) The distribution of power in a shared Bank of England is likely to be on the basis of population.[3] If the UK has a 90% majority on every vote, whose interests are likely to be served?

(2) Since the only real prospect is that the UK bails-out independent Scotland (rather than vice-versa), and Scotland can withdraw any time, how tough would the UK's constraints be to control Scotland's risk taking?

(3) The UK could end the Monetary Union at any time, is this time more likely to be when it is beneficial or disadvantageous to an independent Scotland?

Does this Monetary Union sound like it fulfils the aspiration of independence?

So what are the alternatives?

Which currency option best allows an independent Scotland's "priorities and values" to be expressed?

In the words of the Scottish Government's Fiscal Commission “the creation of a new Scottish currency would represent a significant increase in economic sovereignty.”

This could be achieved. Many new institutions would need to be established. For example, a central bank, a payments system, financial regulators and domestic capital markets to name but a few.

The transition would certainly carry risks.

Once established, independent Scotland could peg its currency to Sterling, allow for occasional adjustments, and, in time, be free to choose tax and spend policies that reflect the priorities and values of Scotland rather than the UK.

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[1] See pvii, Scotland's Future, Scottish Government, (2013).
[2] See p111, Scotland's Future, Scottish Government, (2013).
[3] See the 'shareholder' option on p126, Macroeconomic Framework, Fiscal Commission Working Group, (2013).