EXECUTIVE SUMMARY

"Monetary arrangements are given birth at conference tables, and laid to rest in foreign exchange markets." M Dooley, (1998).

The choice of currency arrangement is fundamental to the economics of independence. It matters much more than simply the notes and coins in our pockets. It determines how monetary policy is managed, whether there is a separate exchange rate policy, exposure to financial sector risks and even the scope for fiscal policy. In many ways, the choice of currency arrangement will determine the economic governance of an independent Scotland.

This report considers the main currency options that would be open to an independent Scotland. Our major assumption throughout the report is that an independent Scotland would make the institutional changes consistent with EU membership. The currency options we consider are a sterling currency union, (re)-introducing an independent Scottish currency (which we call the Scots pound) and the euro zone. Within each currency option there are many alternative arrangements. Credible arrangements within a sterling currency union and the euro zone would require the agreement of the UK government and European Union respectively.

In our view, no currency option is best when considered against all criteria. Therefore, a rational assessment comes down to comparing the welfare consequences of each criterion. We take a different approach to the Treasury and Fiscal Commission Working Group who primarily focus on trade through an Optimal Currency Area framework. Recent events around the world, particularly in Europe, have shown that fiscal sustainability and currency arrangements cannot be considered in isolation. The evidence suggests that the welfare cost of a disruption in currency arrangements and the economic consequences is an order of magnitude greater than other costs.

Assessing currency options is complicated because an independent Scotland would, in economic terms, be a very different country to today. First, Scotland would be an exporter of hydrocarbons while the UK would be an importer. A one-size-fits-all monetary policy may no longer be as appropriate. Second, the Scottish Government would almost immediately have to issue a large amount of bonds to repay its share of existing UK public debt. The division of debt and

1 This report is accompanied by an animation available on YouTube which we hope introduces the main issues in this report to as wide as possible audience http://www.youtube.com/user/NIESRuk


3 HM Treasury is publishing a series of papers on Scottish independence and the Fiscal Commission Working Group is a sub-group of the Scottish Government’s Council of Economic Advisers advising on a macroeconomic framework for an independent Scotland.
practicalities of repayment are important for public finances on both sides of the border. Third, the Bank of England would continue as an UK institution, but without legal responsibility to Scotland.

Each change would have consequences for Scotland’s fiscal position. For an independent Scotland to prosper it requires a ‘hard’ currency; one in which investors are willing to hold long-dated assets at a reasonable price. A necessary condition for a ‘hard’ currency is that government solvency must be beyond doubt. If this condition is met, then a long-term domestic debt market can develop which supports public finances and financial stability. If it is in doubt, then investors and citizens may choose to hold assets in another currency or simply no longer subscribe to government debt issues.

Solvency is the ability to repay and service debts determined by the value of assets exceeding liabilities. The value of a nation’s assets is the marketable value of its physical assets and its expected future primary fiscal surpluses plus any seigniorage, while the value of liabilities is its current and likely future debts. Expectations play an important part in judging solvency. In the wake of the financial crisis, the debt burden of many countries has dramatically worsened leading creditors to question the solvency of even advanced economies much more closely.

Based on OBR projections of UK debt in 2016 and any reasonable division, Scotland would begin its independence with a substantial amount of debt. To illustrate the possible consequences we perform two quantitative exercises. First, we estimate the borrowing costs for an independent Scotland within a sterling currency zone, taking into account different scenarios of initial public debt and deficit levels. Second, we use these borrowing costs to assess the primary surpluses – the difference between total revenues and total expenditures, excluding interest on debt – which Scotland must run to achieve specific debt to GDP ratios 10 years after independence.

- We estimate that an independent Scotland within a sterling currency zone would face long-run average borrowing costs of between 72 and 165 basis points over UK borrowing costs. There is greater statistical precision over the upper bound estimate. Added to the UK average ten year bond yield between 2000 and 2012 suggests borrowing costs would have been between 4.82% and 5.75%.

- Using the lower bound borrowing cost estimate of 4.82%, Scotland would need to run primary surpluses of 3.1% annually order to achieve a Maastricht defined debt to GDP ratio of 60% after 10 years of independence. Given Scotland’s estimated average primary fiscal deficit of 2.3% (including taxes from oil and gas) over the period 2000-2012, running a surplus of 3.1% would represent a fiscal

4 Note that the Maastricht public debt figure for UK public debt is significantly higher than the UK public sector net debt figure.
tightening of 5.4%. These estimates assume that Scotland would receive a geographic share of hydrocarbon reserves and real GDP would grow at 2% annually.

The results of our baseline scenario, where Scotland takes on a per capita share of UK government debt and a geographic share of oil, indicates that a very tight fiscal adjustment would be necessary for Scotland to achieve a 60% debt to GDP target in 10 years. The greater the share of debt and the smaller the share of assets (primarily oil and gas) which Scotland receives at independence, the greater the fiscal adjustment that would be necessary. In turn, the greater the fiscal adjustment, the more vulnerable Scotland would become to adverse shocks (such as a sharp fall in the oil price or a recession), as its scope for adjustment would be smaller.

The greater the amount of public debt an independent Scotland assumes, the greater the importance of retaining some policy flexibility and the stronger the case for introducing a new Scottish currency. There is a close link between the stability of public finances and the banking system, in part because domestic banks hold a high proportion of government debt as its liquid assets. Countries with their own currency have an extra degree of policy freedom which allows them to pursue exceptional monetary policy measures to support the financial system if necessary.

This is not to downplay the risks of introducing a new currency. Whether borrowing costs would be higher or lower depends on the credibility of the Scottish government to reduce its debt burden. Scotland would need a stabilization plan with the same degree of fiscal adjustment. To emulate the other advanced smaller European countries which successfully use their own currencies (Sweden, Norway, Denmark and Iceland), Scotland would need to reduce its debt burden substantially. One option is an assets-for-debt swap (oil and gas reserves for public debt) which would significantly improve its initial debt position. Given that an independent Scotland is also likely to pay a higher rate on servicing its debt than it would receive on its investments, this has economic merit.

There has been no meaningful discussion to date between the two governments on dividing the existing UK public debt and how an independent Scotland would in practice transfer the funds to the continuing UK. A definitive answer to the currency question is impossible as long as this issue is unresolved. If this vacuum continues, it may end up having adverse consequences on both sides of the border, as the credit standing of both the UK and a future independent Scotland are at risk from the uncertainty over how the UK’s existing debt will be divided.

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5 The Maastricht definition of sustainable public finances is government debt not more that 60% of GDP.
6 Assuming an independent Scotland is rated when it issues its first bonds.