Economic aspects of Scottish independence: currency

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This note sets out the pros and cons of different currency arrangements for an independent Scotland.

Contents

1 Summary

"The choice of currency is perhaps the most important economic decision an independent Scottish Government would face"[1]

Scotland will hold its referendum on independence in September 2014. Much of the debate on independence has focused on economic arguments. A central economic issue is the currency Scotland would use if it voted for independence.

The choice of currency has wide ranging economic implications. It affects trade with other countries, fiscal policy (government spending and taxation) and monetary policy (interest rates). It also affects policies relating to financial stability.

An independent Scotland would, in theory, have three main currency options: its own currency, using the Euro and continuing to use the pound as part of a "sterling zone" with the rest of the UK. This note concentrates on the last of these options as it is the Scottish Government's preferred policy.

Such an arrangement would require an agreement to be negotiated between the government of an independent Scotland and the government of the rest of the UK. This would be likely to impose constraints on the level of government borrowing and debt an independent Scotland would be allowed to have. The Scottish Government accepts the need for such constraints but argues that these apply only to *overall* levels of borrowing and debt, leaving scope for fiscal policy to work through the design of individual taxes, for example. There would also need to be agreement on how to minimise risks to the banking system in a "sterling zone".

The Conservatives, Labour and the Liberal Democrats have ruled out sharing the pound with an independent Scotland. The Scottish Government has argued that it would be in the economic interests of the rest of the UK, as well as Scotland, to agree to a sterling zone. Alex Salmond has also linked the sharing of the pound to the share of the UK national debt which an independent Scotland would take on.

If an independent Scotland did not join a currency area with the rest of the UK, its main options would be to introduce its own currency or join the Euro. A new Scottish currency would give greater scope for Scotland to pursue its own monetary or exchange rate policy. It would, however, increase the costs of trading with other countries (including the rest of the UK) and potentially expose Scotland to exchange rate fluctuations. Joining the Euro, is now probably a less attractive option than before the financial crisis. It would increase the costs of trade with the rest of the UK. If Scotland adopted the Euro, its monetary policy would be set for the Eurozone, running the risk that it would be unsuitable for Scotland's economic needs. Based on current UK levels of government debt, it is unlikely that an independent Scotland would meet the convergence criteria for Euro membership, at least initially.

2 Why does choice of currency matter?

The choice of currency is an important economic decision. It affects the economy in a number of ways, including:

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1 House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, HL 152, 10 April 2013, para 54

- **Transitional costs:** the introduction of a new currency would involve transitional costs, such as the costs of introducing new notes and coins, changing prices and contracts to reflect the new currency and the costs as businesses and households adapt to the new currency.

- **Monetary policy:** a separate currency gives a country an extra policy lever through its ability, at least in theory, to run an independent exchange rate/ monetary policy. This can give greater flexibility in adapting to economic shocks. It also allows a country to set interest rates in response to its own economic circumstances. Membership of a currency union means monetary policy is set for the currency area as a whole and may be less appropriate for an individual member of the area.

- **Trade:** sharing a currency reduces transactions costs from having to change currency and removes the risks arising from exchange rate fluctuations. This reduces the costs of trade between countries sharing the same currency.

- **Fiscal policy:** a separate currency allows greater freedom for fiscal policy. Membership of a currency union generally involves accepting constraints on the level of government debt and borrowing.

- **Financial policy:** as with fiscal policy, membership of a currency union often means accepting constraints on policies to maintain the stability of the financial system.

3 Currency options

An independent Scotland would in theory have three main currency options:

- Keeping the pound as part of a formal sterling currency union agreed with the rest of the UK

- The Euro

- A new Scottish currency

This note focuses mainly on the first of these options, as this is the Scottish Government's policy. The other options are also considered below. In theory, there is a fourth option, unilateral use of sterling by Scotland with no agreement with the rest of the UK. It seems highly unlikely that Scotland would choose this option, which is discussed very briefly at the end of this note.

3.1 A formal sterling currency union with the rest of the UK

Introduction

A formal currency union with the rest of the UK would mean Scotland continuing to use the pound. There would be a single official interest rate for the whole sterling area (ie Scotland and the rest of the UK). Scotland would not be able to operate its own, independent monetary policy. This arrangement, which would need the agreement of the rest of the UK, is the Scottish Government's favoured option. In its White Paper, *Scotland's Future,* the Scottish Government said:

> The pound is Scotland's currency just as much as it is the rest of the UK's.

> The expert Fiscal Commission Working Group concluded that retaining Sterling as part of a formal Sterling Area with the UK would be the best option for an independent Scotland and the rest of the UK.
>
> The Scottish Government agrees with that view. Using Sterling will provide continuity and certainty for business and individuals, and an independent Scotland will make a substantial contribution to a Sterling Area. We will therefore retain the pound in an independent Scotland.[2]

In February 2014, the Conservatives, Labour and Liberal Democrats ruled out the possibility of an agreement to share sterling with an independent Scotland. The Chancellor said:

> If Scotland walks away from the UK, it walks away from the UK pound.
>
> […]
>
> We have seen how it would be impossible to construct an acceptable banking union, or fiscal union…
>
> We have seen that we would be ill-served by the monetary policy arrangements, and that the permanence of the currency union would be in serious question from the outset.
>
> On this basis, the official advice I have received from civil servants in the Treasury is that they would not recommend a currency union to the Government of the continuing UK.
>
> Listening to that advice, looking at the analysis myself
>
> It is clear to me:
>
> I could not as Chancellor recommend that we could share the pound with an independent Scotland.
>
> The evidence shows it wouldn't work. It would cost jobs and cost money. It wouldn't provide economic security for Scotland or for the rest of the UK.
>
> I don't think any other Chancellor of the Exchequer would come to a different view.
>
> The Scottish government says that if Scotland becomes independent there will be a currency union and Scotland will share the pound.
>
> People need to know – that is not going to happen.[3]

In an article in *The Scotsman*, Ed Balls said:

> I am clear that the next Labour government cannot enter into a new sterling monetary union to share the pound with an independent Scotland.
>
> […]
>
> I want Scotland to stay in the UK. But if Scotland were to vote to break away, then I do not believe a currency union would be in the interests of either an independent Scotland or the rest of the UK.

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2 Scottish Government, *Scotland's Future*, November 2013, p7

3 George Osborne, Speech on the prospect of a currency union between an independent Scotland and the rest of the UK, 13 February 2014

> And as Chancellor in a UK Labour government after the general election, I simply could not support or recommend to Parliament that we form a currency union with a separate Scotland.[4]

For the Lib Dems, Danny Alexander said:

> As a Scot and as Liberal Democrat Chief Secretary to the UK Treasury, on the basis of this analysis, I couldn't recommend a currency union to the people of Scotland and my party couldn't agree to such a proposition for the rest of the UK.
>
> "The SNP continue to pretend that an independent Scotland could continue to share the pound. It couldn't, without agreement. And because a currency wouldn't work for anyone, it simply isn't going to happen. The SNP now need to work out what their alternative currency proposal is and set it out openly.[5]

A few days after the Conservatives, Labour and Lib Dems set out this position, Alex Salmond made a speech on the economy. In this, Mr Salmond said that the Scottish Government's Fiscal Commission working group had addressed criticisms of the proposed sterling zone. Mr Salmond also linked the currency question to Scotland's share of the UK's national debt:

> If there is no legal basis for Scotland having a share of the public asset of the Bank of England then there is equally no legal basis for Scotland accepting a share of the public liability of the national debt.
>
> […]
>
> We are willing, despite the legal position, to accept a share of liabilities on the basis that there is also a share of the assets – one of which is the Bank of England which holds almost one third of the UK debt.[6]

Arguments for and against a formal sterling currency union

There are a number of arguments in favour of a sterling currency union:

- **Avoidance of transitional costs of changing currency:** there would be costs associated with introducing a new currency. Prices and financial accounts would have to be converted to the new currency. Contracts might have to be re-written. Households and businesses would have to adapt to the new currency. Keeping the pound would avoid these costs. It has also been argued that keeping the pound would make it easier to set up new economic institutions in an independent Scotland and to divide assets and liabilities between Scotland and the rest of the UK.[7]

- **Easier trade with the rest of the UK:** if Scotland were to adopt a different currency to the rest of the UK, this would make trade between the two countries more costly. Cross-border trade would involve the costs of changing currency. There would also be the risk of exchange rate fluctuations. This is an important point given the size of trade flows

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4 "Ed Balls: Currency union with Scots 'won't happen'", *The Scotsman*, 13 February 2014

5 Lib Dems, News story, *For Scotland, separation would be the riskiest step our country has ever taken*, 13 February 2014

6 Alex Salmond speech, 17 February 2014

7 Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, p3

between Scotland the rest of the UK. Around two thirds of Scottish exports go to the rest of the UK.[8]

A sterling area would, however, raise a number of questions. These include:

- **Monetary policy:** Would a single interest rate be suitable for both Scotland and the rest of the UK?
- **Fiscal constraints:** Currency unions generally require their members to accept limits on their budget deficit and government debt. Would an independent Scotland and the rest of the UK be able to agree on these?
- **Central bank:** What would be the arrangements for the sterling area's central bank? How would it be governed? What would its remit be? How would it be accountable to the Scottish and rest of the UK governments?
- **Financial stability:** What would be the arrangements for financial stability?

These issues are considered in more detail below.

Monetary policy

If Scotland and the rest of the UK were both to use the pound in a formal currency area, there would be a single monetary policy covering both countries. In other words, there would be an interest rate set by the central bank for the sterling zone as a whole. By entering a sterling zone, Scotland would forfeit the ability to set its own interest rate.

To the extent that the economies of Scotland and the rest of the UK are similar, this would not be much of a problem. Under these circumstances, interest rates would probably have been similar in the two countries, if they had set interest rates independently. The Scottish Government's Fiscal Commission Working Group has argued that economic conditions are indeed similar in Scotland and the rest of the UK. They have similar levels of GDP per head, productivity and unemployment and a broadly similar economic cycle. Scotland and the rest of the UK are also highly integrated through trade and migration.[9] This means that a single interest rate could well be appropriate for both Scotland and the rest of the UK.

The UK Government has cast doubt on this, arguing that the Scottish and rest of UK economies might start to diverge after independence, due to, for example, different fiscal policies in the two countries and the greater exposure of the Scottish economy to the oil and gas sector.[10] Given the relative size of the two economies, interest rates would be likely to reflect economic conditions in the rest of the UK more than conditions in Scotland. Under these circumstances, a shared monetary policy would become less appropriate for Scotland.

[8] Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, p7. According to the Fiscal Commission, there are no equivalent figures on imports but these are likely to be similar.

[9] Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, p5ff and p16

[10] HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, pages 56 and 66

Constraints on Scottish fiscal policy

Countries which share a currency generally have to accept some constraints on their economic policies as a condition of belonging to the currency union. These constraints often put limits on the budget deficit and government debt.

The Scottish Government accepts that there would need to be some constraints on its level of government borrowing and debt as part of a currency union with the rest of the UK. However, it argues that these constraints relate to *overall* debt and deficit levels, leaving considerable freedom over, for example, the design of individual taxes. It argues that Scotland's financial position means it would be able to meet any such fiscal conditions. The Scottish Government's White Paper said:

> The Scottish Government recognises that a sustainable fiscal framework is important no matter the currency arrangement. However, it is particularly important in a well-functioning monetary union to avoid significant divergences in fiscal balances.
>
> That is why such a monetary framework will require a fiscal sustainability agreement between Scotland and the rest of the UK, which will apply to both governments and cover overall net borrowing and debt. Given Scotland's healthier financial position we anticipate that Scotland will be in a strong position to deliver this.
>
> Within this overarching framework the Scottish Government will have full autonomy to use our fiscal and wider economic independence to boost growth, address any weaknesses in the Scottish economy and take advantage of opportunities for growth. This will need to be managed responsibly.[11]

The UK Government has said that a negotiated agreement "would be likely to include rigorous oversight of Scotland's economic and fiscal plans by the UK authorities".[12] The UK Government's paper on Scotland's currency says:

> The appropriate set of fiscal rules and constraints under which the continuing UK may agree to form a sterling currency union would therefore be likely to be more stringent and less symmetric than those developed in the euro area.[13]

The UK Government has said that these rules and constraints could include some oversight of an independent Scotland's fiscal position by the rest of the UK, regular monitoring of Scotland's fiscal position by the rest of the UK and a mechanism for intervention if fiscal risks which threatened the currency union arose. The UK Government's paper concludes:

> In summary, a formal currency union between the continuing UK and an independent Scottish state could place a number of demands on fiscal arrangements. It would require a more active fiscal policy to stabilise the economy in response to shocks, in a context where market discipline would reduce the scope for fiscal stabilisation. In addition, it would create important fiscal risks for the continuing UK that it would seek to minimise in any negotiation to form a sterling currency union with an independent Scotland. These conditions would be likely to reduce the sovereignty of the new independent Scottish state over its fiscal choices.[14]

[11] Scottish Government, *Scotland's Future*, November 2013, p117
[12] HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 51
[13] HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 61
[14] HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 65
[14] Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, paras 7.43 - 44

Governance of the central bank

A sterling zone would need to make arrangements for a central bank. The Scottish Government's Fiscal Commission's preferred option would be for the Bank of England to be the central bank for the sterling zone. The Commission noted that ownership and governance of the Bank would have to be negotiated with the government of the rest of the UK but that shareholdings could be based on population or GDP. The Commission recommended that the Scottish Government should "seek input" into the remit of the Bank and appointments to key positions. In addition, "the Scottish Government and Scottish Parliament should seek a role in providing oversight of the Bank and its activities." A Macroeconomic Governance Committee could be set up to deal with areas requiring agreement by the two governments.[15] The Scottish Government has said that it is attracted by these proposals and that the Scottish and UK Governments should reach agreement on these arrangements prior to the referendum.[16]

At the moment, the Bank of England's Monetary Policy Committee (MPC) is a committee of experts. Its members are not representative of particular geographical or other interests. The House of Lords Economic Affairs Committee noted that "it would be unacceptable for the MPC to have members representing the interests of a separate country".[17] The Committee also described the proposal that the Scottish Government should have some say over governance of the Bank of England as "devoid of precedent" and "entirely fanciful" and questioned whether the UK Government would agree to them.[18]

The UK Government has said that the Bank of England would operate as the central bank of the rest of the UK. The Government of the rest of the UK would nominate members of the MPC. An independent Scotland would have no automatic right to use the Bank of England as its central bank, although it could try to negotiate such an arrangement.[19]

Financial stability

A formal sterling currency area would also raise financial stability issues. Central banks have traditionally acted a "lender of last resort" providing liquidity to the financial sector. The recent financial crisis has illustrated that sometimes support for the financial sector needs to go further than this and involve public money.

The Fiscal Commission Working Group has expressed "a preference for financial stability to be coordinated across Scotland and the UK" and recommended that "key elements of prudential regulation … be discharged on a consistent basis across the Sterling Zone". This role could be carried out either by the Bank of England or a Scottish Monetary Institute working with the Bank.[20] The Working Group has argued that there would also be

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15 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, paras 3.29 to 3.37

16 Scottish Government, *Currency choices for an Independent Scotland: Response to the Fiscal Commission Working Group*, April 2013, pp 7-8

17 House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, HL 152, 10 April 2013, para 62

18 House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, HL 152, 10 April 2013, paras 69 and 77

19 Letter from Danny Alexander, Chief Secretary to the Treasury to Lord MacGregor, Chairman, House of Lords Economic Affairs Committee, 10 June 2013, p8

20 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, para 7.71 and paras 3.46 – 3.47

advantages for the rest of the UK from close coordination of financial policy between the two countries.[21]

The Commission's report also discussed how the system might work in cases where public money was involved:

> Financial crises require close coordination of monetary, fiscal and macroprudential policy. At the centre of the framework is the proposition for issues of crisis management, resolution and deposit protection to be coordinated on a pan-Sterling Zone basis. This would be consistent with the powers and authority of the Bank of England under the UK Banking Act 2009 and would also reflect the integrated nature of the highly developed financial services market and the need for co-ordinated action to deal with cross border financial institutions. It would also be consistent with the emerging principles underpinning the proposed Banking Union in Europe.
>
> While these activities, in all but the worst of financial crises, are likely to be conducted at arms-length from government, for example by the central bank and financial regulatory authorities. If and when any input was required from a fiscal authority – for example an indemnity was sought to underwrite a particular intervention – this could be coordinated through the 'Macroeconomic Governance Committee'.
>
> Depending upon the nature of the intervention this could be undertaken jointly by both governments in accordance with the shareholder framework as set out above. This would deliver a fair, common and effective approach to ensuring stability across an integrated financial and monetary area.[22]

The UK Government has said that agreement would need to be reached between Scotland and the rest of the UK if the Bank of England, acting as the central bank for the sterling area, could commit public funds. The UK Government's paper said:

> The exact financial stability arrangements for a formal sterling currency union would have to be agreed between the continuing UK and an independent Scottish state to minimise fiscal and financial risks.[23]
>
> and:
>
> It is clear that the coordination of crisis resolution procedures would be a lot more complex with two governments and one central bank than under the current system.[24]

The House of Lords Economic Affairs Committee cast doubt on whether the Bank of England would be willing to provide central bank services (such as being lender of last resort) to financial institutions operating in an independent Scotland. Its report said:

> For the Bank of England to provide central bank services to substantial financial institutions operating in an independent Scotland and regulated by a body reporting to an independent Scottish Government implies that the Bank would accept risks over which it had little control, which seems implausible. [25]

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21 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, para 7.71 and para 7.81

22 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, paras 3.52 to 3.54

23 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 66

24 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 65

25 House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, HL 152, 10 April 2013, para 67

Comment

In January 2014, Mark Carney, the Governor of the Bank of England gave a speech on the issues raised by Scotland and the rest of the UK sharing a common currency. The speech examined the pros and cons of a currency union. In conclusion, Mr Carney said:

> The Scottish government has stated that in the event of independence it would seek to retain sterling as part of a formal currency union. All aspects of any such arrangement would be a matter for the Scottish and UK Parliaments. If such deliberations ever were to happen, they would need to consider carefully what the economics of currency unions suggest are the necessary foundations for a durable union, particularly given the clear risks if these foundations are not in place.
>
> Those risks have been demonstrated clearly in the euro area over recent years, with sovereign debt crises, financial fragmentation and large divergences in economic performance. The euro area is now beginning to rectify its institutional shortcomings, but further, very significant steps must be taken to expand the sharing of risks and pooling of fiscal resources. In short, a durable, successful currency union requires some ceding of national sovereignty.
>
> It is likely that similar institutional arrangements would be necessary to support a monetary union between an independent Scotland and the rest of the UK.[26]

Commenting on Mr Carney's speech, the BBC's Robert Peston said:

> The governor of the Bank of England says he is not giving a view on whether Scottish independence would be good or bad for Scotland and its people.
>
> But Mark Carney will have an influence on the fractious debate over Scotland's future, because of the implications of his assessment of Alex Salmond's ambition that a separate Scotland would be in a sterling currency union with the rest of the UK.
>
> The nub of his analysis is that successful currency unions pool considerable amounts of sovereignty over fiscal - or tax and spending - decisions.
>
> And that currency unions that endure existential traumas (a big hello to our friends in the eurozone) tend to be those lacking the ability to share their public-sector financial resources, and which have limited controls over the propensity of union members to behave in an economically reckless way.
>
> Or to put it another way, opting to be independent within a successful currency union would represent a very constrained form of independence. A Scottish government would have far less ability to tax and spend as it chose, than if it had its own currency - or so Mr Carney makes clear.
>
> Which carries two implications.
>
> First, independence within a currency union might not properly satisfy the yearning for self-determination of diehard activists, since their ability to manage their economy would be limited.
>
> Second, the business of negotiating the terms of a currency union with the rest of the UK would be both make-or-break for Scottish prosperity and hugely complex.[27]

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[26] *The economics of currency union,* Speech by Mark Carney, Governor of the Bank of England, 29 January 2014

[27] Robert Peston, *The sterling price of Scottish independence*, BBC website, 29 January 2014

Martin Wolf, chief economics commentator at the *Financial Times, has* argued that “it would be folly for the rest of the UK to enter a [currency] union with an independent Scotland voluntarily” given the recent experience of the Eurozone. If the rest of the UK did agree to such a union, it would have to protect its interests by imposing “fiscal discipline” on Scotland.[28]

3.2 The Euro

Would an independent Scotland be required to join the Euro?

One option for an independent Scotland would be to join the Euro. In the past, this has been the preferred option of the SNP.[29] The recent problems in the Euro area have made this a less attractive option and John Swinney MSP, the Scottish Government’s Finance Minister, has said that he “cannot foresee circumstances in which an independent Scotland would want to join the Euro”.[30]

If Scotland were to join the Euro, its monetary policy would be determined by the European Central Bank (ECB) which sets interest rates for the Eurozone as a whole. A Scottish Central Bank would need to be established and Scotland would be represented at the ECB.

According to the UK Government, all EU Member States must commit to adopting the Euro in future, unless they have an opt-out, like the UK and Denmark. Such an opt-out would require the agreement of all other EU Member States.[31] The UK Government also argues that as a new state, an independent Scotland would not automatically benefit from the UK’s opt-out from the single currency.[32]

The Scottish Government’s Fiscal Commission Working Group has argued that an independent Scotland could not be required to join the Euro. This is because joining the Euro requires a country to be a member of the Exchange Rate Mechanism (ERM) II for at least two years. Deciding to join ERM II is voluntary according to the Working Group.[33]

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28 “England must reject currency union with Scotland”, *Financial Times,* 31 January 2014

29 House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, HL 152, 10 April 2013, para 26

30 House of Lords Economic Affairs Committee *The Economic Implications for the United Kingdom of Scottish Independence* , HL 152, 10 April 2013, p66

31 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 46

32 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 78

33 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, para 7.37

Countries wishing to join the Euro must meet a number of conditions, known as the convergence criteria (see box below).[34]

> **Convergence criteria**
>
> **Price stability**: inflation less than 1½ percentage points above that in the 3 EU member states with the lowest inflation.
>
> **Public finances**: budget deficit of less than 3% of GDP and government gross debt of less than 60% of GDP.
>
> **Exchange rate**: stable exchange rate against the Euro for at least two years, with no devaluation against the Euro.
>
> **Interest rates:** long-term interest rates not more than 2 percentage points higher than in the 3 member states with the lowest inflation.

At the moment, inflation and interest rate data are available for the UK as whole but not separately for Scotland, making it hard to assess whether an independent Scotland would meet the criteria. The UK's public finances would not meet the convergence criteria. In 2012/13, debt was 88% of GDP and the deficit was 5.2%. While the UK deficit is forecast to fall below the 3% reference value in 2016/17, debt is forecast to be over 90% of GDP in each year between 2013/14 and 2017/18.35 While Scotland's public finance position would depend on how the national debt was divided up, the margin by which the UK is above the reference value suggests than an independent Scotland might also fail to meet the debt criterion, at least initially.

It seems likely that if Scotland wanted to join the Euro, it would need to establish its own currency first (see section 3.3 below). This is because one of the conditions of joining is that a country's currency is stable against the Euro. No country has joined the Euro without having had its own currency first. The UK Government has said that this condition would not be met if Scotland retained the pound and the Fiscal Commission Working Group said "short of special dispensation, joining the Euro would require the establishment of a Scottish currency that demonstrated stability with the Euro for a period of time".[36]

What would be the economic consequences of adopting the Euro?

Transitional and Transactions costs

Adoption of the euro would mean one-off transitional costs related to the introduction of a new currency. These would include the costs of changing notes and coins and costs faced by households and businesses in adapting to the new currency.

Using the Euro would increase the costs of trade with the rest of the UK as this would incur transactions costs of changing currency. There would also be greater risk from a fluctuating exchange rate. On the other hand, adopting the Euro would reduce costs for Scottish

[34] Full details of the convergence criteria are on the ECB website

[35] Office for Budget Responsibility, *Economic and fiscal outlook*, December 2013, Table 4.39, p159

[36] HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, p 78 and Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, p32

businesses of trading with other members of the Eurozone. The UK Government has argued that as Scottish exports to the rest of the UK are currently much greater than to other EU Member States, the transactions costs of using the Euro are likely to outweigh the benefits.[37]

Monetary policy

Interest rates would be set for Scotland by the ECB. As the ECB sets interest rates for the Eurozone as a whole, and Scotland would be a small part of the Eurozone, Scottish economic conditions would have a limited influence on the ECB's decisions. This would increase the risk of interest rates being set at an inappropriate level for Scotland. The UK Government has argued that the current arrangements where monetary policy is set by the Bank of England for the UK as a whole are likely to be better suited to Scotland than the ECB's policy set for the whole of the Eurozone. The Scottish Government's Fiscal Commission has also said that Scotland's economy is less well aligned with the Eurozone than with the rest of the UK.[38]

3.3 A new Scottish currency

An independent Scotland could decide to introduce its own currency. The Fiscal Commission's report notes that Denmark, New Zealand, Singapore and Norway are of a similar size to Scotland and all have their own currency.[39] If this option were chosen, Scotland would need to set up its own central bank to operate monetary policy and oversee the financial system.

An independent currency could take a variety of forms including:

- a freely floating exchange rate set by market forces
- a managed exchange rate where the Scottish Government would aim to keep the exchange rate in a band against another currency
- a currency board arrangement where there would be full convertibility of the Scottish currency at a fixed rate against another currency.[40]

The main advantage of adopting an independent currency is that it gives a country an extra instrument of economic policy. A country with its own currency can adopt its own interest rate/exchange rate policy which can help manage the economy. This policy could be tailored exclusively to economic conditions in Scotland, unlike, for example, using the Euro where interest rates are set by reference to the Eurozone as a whole. The Scottish Government's Fiscal Commission Working Group has said:

> In the long run, the creation of a new Scottish currency would represent a significant increase in economic sovereignty, with interest rate and exchange rate policy being two new policy tools and adjustment mechanisms to support the Scottish economy.[41]

A floating currency allows greater scope to use monetary policy to support the domestic economy. Under pegged exchange rates and, to an even greater extent, currency board

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37 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, p 82
38 Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, p22, p27 and p29
39 Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013, page 27
40 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 90
41 Fiscal Commission Working Group, *First Report – Macroeconomic Framework*, February 2013, para 7.12

arrangements, monetary policy is focused on maintaining the exchange rate, rather than responding to domestic economic conditions.

There are also disadvantages of an independent currency. First, there would be one-off costs of introducing the new currency – issuing new notes and coins and withdrawing the old currency and costs of adjustment for households and businesses. The UK Government has suggested that capital controls may be required to prevent large flows of money into or out of Scotland if the Scottish currency were expected to appreciate or depreciate against sterling.[42] Contracts would need to be redenominated in the new Scottish currency. The UK Government's analysis of the transitional costs concludes:

> Overall, the transition costs of introducing an independent Scottish currency are not inconsequential. However, the experience of the introduction of the euro, which was a much larger logistical exercise, covering many countries, makes clear that while there would be costs involved in the transition, they are not insurmountable.[43]

Second, an independent currency means greater transactions costs when trading with other countries as trade would require currency to be converted and a fluctuating exchange rate would mean greater risk for businesses. This would apply to trade with both the rest of the UK and other countries if Scotland had its own currency.

Third, large currency fluctuations can cause economic instability. Large international capital flows can lead to significant changes in the exchange rate, unrelated to domestic economic conditions. The UK Government's analysis of Scotland's currency options argued that a new currency for an independent Scotland could be at risk of a volatile exchange rate due its large oil and gas sector.[44] The Fiscal Commission has, however, noted that oil and gas is typically traded in dollars reducing the effect on a Scottish currency. These costs could also be reduced if Scotland were able to manage its exchange rate by pegging it to another currency. Interest rates would then have to be set to maintain the peg rather than to meet the needs of the domestic economy. Given the size of international capital flows, national governments can find it difficult to defend an exchange rate peg. For example, the UK's experience with the Exchange Rate Mechanism on Black Wednesday shows the limitations of a government's ability to maintain a target exchange rate in the face of a large scale speculative attack.

3.4 Unilateral use of sterling: sterlingisation

One option for an independent Scotland would be to use sterling unilaterally – i.e without a formal agreement with the rest of the UK. This is sometimes referred to as "sterlingisation" There are examples of countries which have opted unilaterally to use another country's currency. These include Panama which uses the US dollar (referred to as "dollarisation") and Montenegro which uses the Euro. This policy is often used by countries which have a poor economic record.[45] Linking to another currency is seen as a way of increasing economic credibility. This policy would create problems for Scotland's large financial

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42 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 91
43 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, page 91
44 HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013, para 154 and Box 1C page 35
45 John Kay, "Scots who want to leave the UK must be ready to drop sterling", *Financial Times*, 24 April 2013

services sector as it would mean no access to central bank services, such as lender of last resort.[46] For these reasons, this option does not seem particularly relevant to Scotland.

4 Sources of further information

UK Government and Bank of England

HM Government, *Scotland analysis: Devolution and the implications of Scottish independence*, Cm 8554, February 2013

HM Government, *Scotland analysis: Currency and monetary policy*, Cm 8594, April 2013

HM Government, *Scotland analysis: Assessment of a sterling currency union,* Cm 8815, February 2014

Speech by Mark Carney, Governor of the Bank of England, *The economics of currency unions*, 29 January 2014

Scottish Government

Scottish Government, *Scotland's Future,* November 2013

Scottish Government, *Scotland's Economy: the case for independence*, May 2013

Scottish Government, *Currency Choices for an Independent Scotland: Response to the Fiscal Commission Working Group*, April 2013

Fiscal Commission Working Group, *First Report – Macroeconomic Framework,* February 2013

Fiscal Commission Working Group, *First Report Annex – Assessment of key currency options*, February 2013

House of Commons debates

Currency in Scotland, Westminster Hall debate, 12 February 2014 cc292-318WH

House of Lords

House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence*, 2nd Report of Session 2012-13, HL Paper 152, 10 April 2013 (see chapter 3 in particular).

See also House of Lords debate on the report, HL Deb 26 June 2013 cc761-80[47] The UK Government's response to the Committee's report is attached to a letter from Danny Alexander, Chief Secretary to the Treasury to the Committee's' chairman, Lord MacGregor, 10 June 2013

[46] House of Lords Economic Affairs Committee, *The Economic Implications for the United Kingdom of Scottish Independence* , HL 152, 10 April 2013, p19

[47] There are no SNP members of the House of Lords and therefore no SNP representation on the Lords Economic Affairs Committee. The Committee did, however, take evidence from SNP politicians such as John Swinney, the Scottish Government's Finance Minister.