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Scottish independence — the Currency Conundrum

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On 18 September 2014, Scotland will vote in a referendum on whether it should become independent from the rest of the UK. A key question: **what currency would an independent Scotland (iScotland) use**, and what are the implications? The pro-independence campaign (the 'yes' campaign) favour retaining Pound Sterling, with a formal currency union between iScotland and the remainder of the UK (rUK). This blog examines the options on currency and summarises the implications.

1. **Currency union.** The scope of any currency union would be negotiated between iScotland and the rUK, but both states would continue to use the pound and continue to rely on the Bank of England as a lender of last resort. This option offers advantages to both iScotland and to the rUK — in particular, by minimising transaction costs. An iScotland would have influence on the central bank's monetary policy, likely proportional to iScotland's economy. Most commentators accept that a currency union requires a compact between participating states thereby ceding national control over fiscal policy. For example, Eurozone Members subscribe to the Stability and Growth Pact. In the view of Mark Carney, the Governor of the Bank of England, an iScotland/rUK currency union would need to "go further" than the Eurozone pact, to "equalise, to an extent, some of the inevitable differences [between Scotland and the rUK]", an outcome that Mr Carney described as being "incompatible with sovereignty", to much publicity in the UK press.

2. **Sterlingisation (using Sterling, but without a currency union)**. Certain small states use the currency of larger neighbours, such as Panama's use of the U.S. dollar. This arrangement wouldn't require a formal agreement between iScotland and the rUK. There are differing degrees of Sterlingisation. At one end iScotland would have no central bank (like Panama). Alternatively it could have a central bank with limited, but no currency-issuing powers (like Montenegro, which uses the Euro, although not in the Eurozone). Full Sterlingisation would leave iScotland with no independent monetary policy (see page 18 of here). Under either approach, the Bank of England would no longer consider the needs of iScotland, then a foreign country, when setting interest rates. Money supply in iScotland would be heavily influenced by the balance of trade, with a trade surplus increasing money supply with inflationary effects and a deficit being deflationary. On the plus side, Sterlingisation would have relatively low transition costs in a post-independence period, and transaction costs would be kept down.

3. **Introduce a new Scottish currency.** With floating currencies such as the Dollar and Sterling, exchange rate adjustments are driven by market demand. A floating currency would give iScotland maximum control over its monetary policy, although currency volatility could shock the economy. A new currency would have significant transaction costs, through setting up a central bank (which would need to establish credibility), and also to domestic businesses. Redenomination would be complex, with uncertainty and possible litigation between counterparties that originally contracted in Sterling. Capital controls might be needed in any transition period to reduce capital flight if deposit-holders fear risk of losses on redenomination. Fixing/pegging the new currency against an anchor currency, such as Sterling, could have advantages, such as allaying the fears of deposit-holders and lowering volatility, but monetary policy would need to be geared towards defending the peg, rather than to domestic economic priorities. A further challenge for iScotland is that on account of its large oil and gas sector fluctuations in energy prices would significantly impact on the exchange rate of a floating currency, or make it additionally difficult to keep a fixed currency pegged at the anchor currency. Furthermore, the interaction between the energy sector and exchange rates can make the non-energy sector less competitive (known as Dutch disease). Norway, a country with significant oil and gas manages this risk by investing significant oil and gas revenue abroad (see).

The debate on currency has been hard-fought between the ‘yes’ and the ‘no’ campaigns. The UK’s three main political parties have ruled out a currency union, and pressurised the ‘yes’ campaign to specify a preferred ‘plan b’ for iScotland. In response, the ‘yes’ campaign have argued that following a ‘yes’ vote, a currency union would be inevitable, and that iScotland would reject any portion of the UK’s existing national debt if the rUK refused a currency union. The ‘yes’ campaign has ruled out joining the Euro. Since 1993, all new states admitted to the E.U. have been required to commit to Euro membership. Although the ‘yes’ campaign’s policy is for iScotland to join the E.U., they argue that iScotland can negotiate an opt-out from joining the Euro. GlobalPolicyWatch will examine this topic in a future blog on iScotland’s relationship with, and route for joining, the E.U.

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