Enlightening the Constitutional Debate

The fifth in a series of discussion events to enlighten the public debate on Scotland's constitutional future.

Currency, Banking and Financial Services after the Scottish Referendum

24 July 2013

at the British Academy, Carlton House Terrace, London

This seminar was the fifth in a series of seminars organised by the Royal Society of Edinburgh (RSE) and the British Academy (BA), aimed at Enlightening the Constitutional Debate ahead of the Referendum on Scotland's constitutional future. It took place at the British Academy in London, and assembled invited economists, academics and other experts to discuss the options for currency, banking and the financial services following the Referendum.

This seminar was conducted under the Chatham House Rule, which encourages frank exchanges by not attributing comments to named participants. Each speaker presentation was followed by a Question and Answer session, and the seminar concluded with an open, roundtable discussion.

It should be understood that the opinions expressed in this report reflect the views of participants in the discussion and should not be taken to represent the views of the RSE or the BA, nor of their Fellows.

In the event of Scotland becoming independent, it will have to confront decisions around what currency to adopt and how to regulate banking and financial services. Monetary policy issues have an overlap with fiscal issues, to the extent that there is interdependence between monetary and fiscal policy. Moreover, the background context of a significant budget deficit in the UK and the aftermath of the financial crisis make the issues considerably more complicated than they would have been in 2008. Thus it is important to learn from the experience of other nations which have made related decisions, as well as looking at the specific issues facing Scotland. This seminar examined the experiences of other countries which have undergone a break-up similar to that proposed for Scotland and the UK. It then examined the options available to Scotland in the event of independence, and gathered views and feedback on these options.

Experience from other countries

This seminar opened with a discussion of the experience from other countries which have broken up a monetary union. The examples discussed were Czechoslovakia and Ireland.

Czechoslovakia

Czechoslovakia is one of few monetary unions to have broken up without a war. It is therefore a good comparator for the Scotland–UK debate. There has been some discussion as to whether Austria–Hungary represents a good comparator. However, the break up of this monetary union occurred after a war, and is therefore not analogous. Czechoslovakia underwent a peaceful breakup of its monetary union, which was managed with diplomacy and negotiation. In this respect it represents a much better analogy for Scotland and the UK. It was observed in discussion that when Czechoslovakia ceased to exist, a monetary union was initially maintained; however, this was dissolved after only six weeks. Ultimately, the two currencies (the Czech koruna and the Slovak koruna) were formally separated and two national currencies introduced. It was suggested that there are three main lessons that can be learnt from the Czechoslovakia example.

First, credibility is of paramount importance. In the Czechoslovakia case, it was observed, there was no clear commitment from the two countries (the Czech Republic and Slovakia) to maintain monetary credibility. The monetary union was announced as a temporary arrangement to be re-evaluated after six months, and the institutional set-up of these two countries was flawed; there was no central bank; instead, the two countries set up their own central banks and appointed committees to agree monetary policy. The committees were intended to decide upon monetary policy for the union. Each country possessed the same number of votes, but there was no provision in place to deal with disagreements. Credibility was clearly lacking from these attempts at a monetary union.

The second lesson is that in this example, betting against the common currency was very easy and cheap. The Slovak currency was seen as weaker, so people began transferring money into the Czech Republic. During the monetary union, transferring money was easy, and could be done without much cost. It was suggested that in the Scotland and the UK case, the transfer of currency from Scotland into the UK, or vice-versa, would be even easier because of online banking. The gain of transferring money in the Czechoslovakia example was around 20%, which was gained through the depreciation of Slovak currency.

The third lesson to be taken from the Czechoslovakia example is that when the monetary union was severed, the cost was not huge. Trade between the two nations was already declining due to the opening of Czechoslovakia to trade with the West, and at the time of the break-up, this decline accelerated and lasted for around two years. It was suggested that this extended the recession that both countries were experiencing at the time by one or two years.

At the break-up of the monetary union, introducing separate currencies was very easy. It simply involved attaching stamps to the face of bank notes to indicate which currency they represented. This meant that there was not the need to print new bank notes. The point was made that, potentially, it would be even easier for Scotland to have its own currency in the event of separation from the UK, because Scottish banks already issue bank notes.

Ireland

In 1922, Ireland became the Irish Free State. At this time, all Irish banks were headquartered in Ireland, and all issued their own notes. Sterling circulated freely within Ireland and, at the time of its separation from the UK, currency was not considered a problem, because 98% of Ireland's trade was done with the UK. A big issue, however, was concern with interest rates and inflation, and with minimising uncertainty. Shortly after separation from the UK, Ireland introduced the Coinage Act. This was the very first act of change, and replaced the UK Sovereign who appeared on coins, with the cláirseach, the Irish harp. At this point, it was decided not to break the link with sterling, in order to maintain the credibility of the currency. In 1926, a Currency Commission was set up, influenced by the Federal Reserve. This Commission decided to maintain the link with sterling and to take the currency board route (i.e, to maintain a fixed exchange rate with the UK currency). This was formally introduced in 1928, and notes issued in Ireland after this were issued jointly by banks and the Currency Commission. In 1942, the Central Bank Act was passed, which provided for standard central bank powers; however, these were not worked out in any serious way until the late 1960s/early 1970s. During this time, residents of Ireland could be handed a UK or an Irish note in a shop and it made no difference; the value of the two was the same.

In the late 1960s, decimal currency was introduced, and this again prompted consideration about whether Ireland should

break its link with sterling. It was decided to maintain the link. However, in 1971, a new Central Bank Act was passed, which effectively gave the Central Bank the power to agree to sever the link, a power which had not existed formerly. Ireland never formally broke the currency link with the UK; rather it became engaged in discussions about whether to join the European Monetary System (EMS), as did the UK. Relatively late on the UK decided not to join. At this stage, Ireland's trade with the UK was down to 50% as opposed to 98%, and it was felt that there should be some diversification from British markets. Ireland therefore joined the EMS in 1978.

Having considered the Irish example, it was suggested that lessons for Scotland –should it separate from the rest of the UK – could be drawn from this. In the Irish example, movement was very gradual, with the Central Bank taking on more powers only very slowly and gradually. It was suggested that it may not be possible for such gradual moves to be made today, in the event of Scottish independence, because of the general speed with which things now happen. In Ireland, there was a big question around whether Ireland as a small nation had the skills to manage its own currency. It was pointed out that Ireland never had a voice at the sterling table and had no real influence over what was happening with monetary policy in the UK. There was recognition that Ireland was a small, open economy, and that it might therefore be sub-optimal as a currency area on its own. As such, the decision for Ireland was whether it should stick within the sterling currency area or join the EMS. The link with the UK was ultimately severed very quickly. It was suggested that there is an issue with the timing of these things and thinking things through thoroughly. This worked well in Ireland during the early stages, but less so later on.

When the issue of the Euro came up, Ireland was in a position of choosing between two sub-optimal positions. From an Irish point of view, being in the same monetary union as the UK made sense, being with the UK alone made less sense, as did being in a union without the UK. It was suggested that Brussels was always very generous if you were going to follow its policies, and this became apparent when Ireland joined the EMS. There was a feeling that Ireland, as a small, open economy, was always going to be linked with either the UK or Europe, and the Euro delivered on low pricing and low interest rates, so became the favoured option for businesses and consumers.

Questions and Answers

It was suggested that in the Ireland example, communication with London regarding Ireland's monetary future was lacking. The question was therefore posed as to whether there had been much debate with London, or whether decisions about Ireland's currency were made entirely unilaterally. There is a question, with regard to Scotland's constitutional future, around the need for debate between Edinburgh and London on the future of Scotland's currency. In response, it was observed that in the Irish example decisions made, to leave the sterling union and adopt the euro, were very much Irish decisions. There was a courtesy relationship between Ireland and the UK. It was also observed that once the suggestion had been made that Ireland might break the link with sterling, the markets did not wait for this decision to be formalised.

A question was raised as to whether there was any evidence, in the Irish example, of constraints on fiscal policy occurring as a result of the link with sterling. It was observed that Ireland inherited no debt when becoming an independent state[1] , and that this is unlikely to be the case for Scotland should it become independent. In answer it was suggested that UK policy at that time fitted reasonably well with where Ireland was, and that by and large it worked to Ireland's advantage to be within the sterling regime. With regard to fiscal policy, it was observed that Ireland tended to look to the UK for changes to fiscal policy, and tended to follow the UK on this. The question of fiscal independence was not tested; there was no Irish involvement in the setting of UK monetary policy.

A question was raised about credibility, and whether any lessons can be learnt from Ireland in terms of establishing a credit rating; in particular, whether there is anything from the Ireland example that would be done differently now. In response, it was suggested that at the time there was a lot of concern in Ireland that the country was not ready for the break with the UK, and that decisions had been made very quickly. A question was raised about investment and what happened in the two examples, of Czechoslovakia and Ireland, with regard to investment before and after the break up of the respective currency unions. With regard to Czechoslovakia, the response was given that there was not a major difference. The Czech Republic was seen as a more attractive destination for investment, so funds were not readily moving east before the break-up of the currency union. However, there was some expectation at this point that if Slovakia was to become independent they would be better able to manage the flow of investment. This did not happen immediately after the break-up of the currency union however; only when there was a clear prospect of Slovakia entering the European Union and the Government began implementing 'sound' economic policies, did Slovakia come to be seen as a favourable destination for manufacturing etc. With regard to Ireland, it was pointed out that a lot of British companies in Ireland began gradually moving out in the run-up to Ireland's break with sterling. Ireland had a Foreign Direct Investment Strategy for bringing in foreign (mostly American) multi-nationals, and Ireland's link into the European currency union at that time attenuated some of the flows of investment.

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[1]This observation was made at the roundtable discussion, but it was commented afterwards that the Anglo Irish Treaty of 1921 stated; "The Irish Free State shall assume liability for the service of the Public Debt of the United Kingdom as existing as the date hereof and towards the payment of War Pensions as existing at that date in such proportion as may be fair and equitable, having regard to any just claim on the part of Ireland by way of set-off or counter claim, the amount of such sums being determined in default of agreement by the arbitration of one or more independent persons being citizens of the British Empire."

The point was raised that with regard to the break-up of Czechoslovakia, at the time this seemed like a huge event, but now this event does not seem so huge. The Czechs are happy not to be in the Euro and the Slovaks are happy to be in the Euro. It was asked whether this observation can be generalised. The response was that it probably can be; the separation of Czechoslovakia into two distinct states allowed two peoples to have Governments closer to their preferences.

The Options (for Scotland)

In discussing the currency options facing Scotland in the event of independence, the following questions were posed: what do we mean by money and what is the purpose of it? In considering examples of currency options, it was observed that Ecuador has no currency of its own, but uses the US dollar. The Ecuador option, it was suggested, is one of the possible options for Scotland. In all, it was suggested that there are three basic possibilities for Scotland: it could join the Euro; continue to use sterling; or have its own currency.

Joining the Euro

On the possibility of Scotland joining the Euro, it was suggested that this option does not provide a sensible long-term basis for economic policy. It was observed that joining the Euro if the rest of the UK is outside is not an optimal currency-area solution for Scotland. Further, it is unlikely that such a solution would be accepted by Europe, since an independent Scotland is unlikely to be able to meet the criteria for joining the Euro, which will be more tightly enforced in the future than has previously been the case. Should it become a member of the EU, however, Scotland would be required to accept the Euro as the currency of the European Union; it was suggested that this could be got round with a loose promise by Scotland to adopt the Euro in the distant future. In reference to this option, it was noted that as soon as the possibility of Scotland joining the Euro is created, the markets are likely to respond to that possibility.

Monetary union with sterling

It was suggested that monetary union is not a straightforward option, and is made less so by the problems the Eurozone has recently experienced. It is now a conventional political and market position that it is difficult, if not impossible, to achieve a stable currency union unless this is accompanied by banking or fiscal union, or at least a step towards these. It was suggested that this is in fact an exaggerated position, and the example of the US was referred to, as a nation which has currency union without, in any real sense, a fiscal union. It was pointed out that there are 51 treasuries in the US, so that California, for example, has its own budget and its own debt. This offers a counter-example to the idea that currency union must be supported by fiscal and banking union. However, it was suggested that the very fact that those in political and market circles believe that fiscal and banking union matters, even if this is not necessarily the case, will make the negotiation of an acceptable monetary union between Scotland and the UK difficult. The point was made that in any such negotiation, account would have to be taken of the fact that an asymmetry exists, with Scotland accounting for around only 8.5% of the monetary union, so that the rest of the UK would expect oversight of Scotland's economic policies. It was suggested that the negotiation of monetary union would, on that basis, prove very difficult, with Scotland unlikely to be able to negotiate acceptable terms.

Unilateral use of sterling

The alternative to maintaining a currency union with the rest of the UK would be for Scotland to follow the Ecuador model, and to use sterling unilaterally. Ecuador is the largest country not to have its own currency, but there are lots of other interesting examples of this around the world. Montenegro, for example, uses the Euro without the agreement of the European Central Bank. The question was therefore raised as to whether Scotland could do the same. It was suggested that it probably could, although it is unlikely that it could print its own notes. The unilateral option would therefore mean that an independent Scotland could not print its own notes: Scottish banks would simply be part of the rest of the UK's financial system, and Scotland could not have a separate monetary policy. This limits the availability of fiscal policy, but perhaps less so than a monetary union would.

Independent Scottish currency

It was suggested that having an independent currency is a serious option for an independent Scotland. On the subject of the negotiation of a monetary union with the UK, it was suggested that this would only be possible to conduct on the basis that the independent currency was the default option, which would be pursued if acceptable terms of the monetary union failed. The independent currency could in turn either be pegged to sterling or allowed to float unilaterally. It was observed that relevant comparisons can be offered by Denmark, which has its currency pegged to the Euro, and Hong Kong, which has its currency pegged to the dollar. It was pointed out that both of these currencies would appreciate against the Euro or dollar respectively if they were free to float. Sweden offers an example of a nation which has a currency that floats loosely against the Euro.

Concluding the discussion on the currency options available to an independent Scotland, two final remarks were made. The first was that there has been a tendency to assume the results of this process will not be chaotic. It was suggested that this cannot be safely assumed. The only reason there has not been more speculation on this issue already is that not many people in financial circles believe that the Referendum will go in favour of independence, so the possibilities are given less attention. The second point was around what was referred to as an insufficiently discussed question; the relative negotiating positions of the parties to the debate – Scotland, the UK and the EU – and what happens if agreement is not reached. In relation to the current discussion, it was pointed out that it is not possible not to reach agreement; if Scotland

becomes independent there will have to be some agreement. It was observed, however, that there is no agreement on the urgency of the negotiations. The EU and the UK have no interest in achieving a rapid outcome, but the position of the Scottish Government is very different. The Scottish Government needs answers to questions which the other parties to the negotiations do not. The real difficulty for Scotland, it was concluded, will be in achieving acceptable results to these negotiations on some quite difficult issues.

Views on the Options

Responding to the discussion of an independent Scotland's currency options, it was suggested that a move could be made quite quickly away from talking about the Euro or sterling options, on the basis that these are not seen as credible or realistic at this point in time. Focus was therefore directed towards the issue of a formal sterling union. The earlier point about the US providing a relevant example of how the difficulties of fiscal and banking union might be surmounted was referred to, and the point made that the US has a very strong political union, which substitutes for a fiscal and banking union. There is no anticipation that there will be a change of currency in the states of the US. This is not true in the Euro area, and is much less likely to be true in an independent Scotland, given the political divergence that will be generated in the process of Scotland potentially becoming independent. It is therefore still necessary to decide how feasible it is to get around the challenges of fiscal and banking union if there were to be a formal monetary union between Scotland and the rest of the UK.

Discussing what these challenges are, it was observed that common agreement suggests that wherever there is a monetary union, there is greater pressure on fiscal policy. Within a currency union, there is a need for greater fiscal stabilisation, so the question was posed as to how this stabilisation might be achieved when monetary policy cannot operate and the automatic fiscal transfers that currently exist between Scotland and the rest of the UK are lost. It was suggested that this poses a fundamental coordination problem, because while, in theory, an independent Scotland could just replicate any fiscal transfers required itself, the reality is that neither the benefits nor the costs of fiscal policy are born solely by the implementing agent. Rather, the impacts of fiscal stimulus tend to leak across currency unions. The assumption with regard to the Eurozone was that if any one country got into difficulty, it could increase its own fiscal deficit to stabilise the economy, without the need for a transfer across national boundaries. This only works for small economic shocks, however. When there are large shocks, as seen in Spain and Ireland, this has been shown not to work.

Examining the potential solutions to these challenges, it was pointed out that simply designing a better set of deficit and debt rules for Scotland and the rest of the UK is not a realistic solution. There is something more fundamentally challenging occurring in the Scotland case, not least the asymmetry of the relationship between Scotland and the rest of the UK, referred to and characterised earlier. This asymmetry leads to a much greater asymmetry of fiscal risk between the two nations, which will make any set of rules even more challenging than the current blueprint of the Eurozone. Further difficulties exist in the size of Scotland's banking sector, which raises major problems. There is also the question of whether the Bank of England could provide lender-of-last-resort facilities to an independent Scotland. It was pointed out that the Bank of England is accountable to UK Parliament under UK law, so it is not straightforward to see how the Bank of England could be allowed to commit these facilities without some sort of supporting political process. It was observed that there are also solvency concerns for Scotland's very large banking sector, in the event of crises. There would therefore need to be an arrangement between the Scottish and UK Governments to account for the large risk that the rest of the UK would be bearing if Scotland's financial sector remained as large as it is at present.

Moving on from the discussion of the challenges and risks of a monetary union, the views of the Scottish Government were brought to the fore. It was observed that there will be three issues facing the Scottish Government in relation to its currency options. These are: which currency option to choose; what will be required to deliver that currency option; and what the merits of the chosen currency option are.

On the first issue – the choice of currency option – it was observed that the Scottish Government has said formally that it would recommend retaining sterling as part of a formal monetary union, seeing this as the best option, in particular with regard to trade and flows of labour and capital. It is also thought to represent the best option for any period of transition in which Scotland moved from being part of the UK to being independent, in particular in relation to the division of assets and debt. Finally it is thought to represent the best option with regard to governance, sustainability and stability, on the basis that a formal monetary union would come with other agreements, for example monetary and fiscal policy and financial stability.

On the second issue – what is required to deliver that option – it was suggested that there is a need to negotiate with the UK, and that in the proposed time-line for independence there is an explicit period built in for negotiation. It was suggested that the Scottish Government proposal is to have an eighteen-month negotiation period with the UK and the EU immediately following a 'Yes' vote in the Referendum, although the point was raised that this is complicated by the fact of UK elections prior to the conclusion of the proposed negotiation period, and by other factors. It was pointed out, however, that the negotiation period has been built in to the timetable for a move towards independence, in the event of a 'Yes' vote. The Scottish Government believe that the model of retaining sterling within a monetary union would benefit the UK. It was observed that there is an argument about UK institutions and who they are currently responsible to. Again, the Scottish Government position is that the Bank of England is a UK institution which serves the whole of the UK and

would be part of any negotiations, irrespective of which currency options an independent Scotland decides to take.

On the final issue – the merits and risks of the proposed currency option – the questions were posed as to whether the UK Government would agree that this model was sustainable, and what this model would deliver to the Scottish people. On the question of sustainability, it was pointed out that any economy can be subject to an external or an asymmetric shock, and that in taking forward the proposed arrangement, the Scottish Government would accept monetary policy created at the sterling zone level and agreements on fiscal aggregates. On this basis, the UK Government would gain a lot of control over fiscal issues in Scotland, although the monetary side would look broadly the same. It was suggested that for the UK Government, retaining control over fiscal policy is regarded as key. With regard to what this model would deliver for the Scottish people, it was suggested this process of a formal monetary union would facilitate them getting the Government they wanted. The point was made that small, open economies do not tend to have much scope for creating their own monetary policy, but tend to take this from elsewhere (for example the Eurozone). Neither do they set their own financial regulation; this is done at the international level.

Returning to an analysis of the available currency options, the suggestion was made that none of the currency options for an independent Scotland dominate across all selection criteria. For example, the best way to minimise transaction costs in cross-border trade is by using sterling, whether independent or not, but having one's own currency gives most flexibility in setting monetary policy. The decision on which currency option to choose therefore comes down to comparing the consequences of the different criteria. It is clear from historical cases of currency unions with separate governments and different economies, that unions can be unstable and vulnerable to capital flight. It was suggested that the welfare costs (i.e. the consequences to the economy as a whole) of this outcome far outweigh the welfare costs of changes to exchange costs. Therefore, any currency arrangement has to be robust in defending the economy against capital flight.

It was observed that much of the debate so far has thought about currency as a medium of exchange, and the consensus view has therefore been that Scotland should continue to use sterling. It was suggested that a more appropriate approach is to see currency as a store of value, with focus being on Scotland having a hard currency. A 'hard' currency was explained as one in which investors are willing to accept long-term debt contracts in that currency, at a reasonable price. This emphasises the importance of government solvency, market expectations and the capital market infrastructure of a country. A pre-requisite of being considered a 'hard' currency is that the solvency of the sovereign is beyond doubt.

If Scotland used sterling, the value of the debt it issued would be limited to the expected sum of future primary fiscal surpluses in Scotland. This is simply the fiscal constraint that all governments face. If the expected surpluses are not enough, this translates into expectations of default. The question was therefore posed as to how this solvency condition could be assessed.

It was posited that one way to get at this issue is to estimate the interest rate spreads of Eurozone countries against Germany between 2000 and 2012, as explained by certain macroeconomic factors. The parameters could then be used to estimate the spread that a hypothetical independent Scotland's debt would have over Germany. Given the closeness of German and UK bond yields, this could be a reasonable proxy for the cost of Scotland's debt versus the rest of the UK. Initial estimates suggest that this spread could be very significant.

It was suggested that there would be several implications of sharing the same currency. First, independence would imply two very different countries to those that exist within the UK today; Scotland would be an oil exporting country and the rest of the UK would be an oil importing country. This means they would be more likely to have asymmetric shocks in future. It was suggested that under any reasonable governance structure of the Monetary Policy Committee (MPC), there is almost no means of adjustment to country-specific shocks within a sterling monetary union. In addition, real economic imbalances are mirrored by financial imbalance, but the lack of capacity for a flexible fiscal response in an independent Scotland might mean that there would be no obvious corrective mechanism. Finally, the point was made that with the high cost of capital and the economic consequences of this, there is a question as to whether there would be strong political will to maintain the currency union, particularly if people in the UK were seen to be able to borrow at much cheaper rates than people in Scotland. It was questioned whether an independent Scotland, even using sterling within a currency union, would have a hard currency regime.

In agreement with an earlier point in the discussion, it was suggested that a fiscal union is not always necessary for a monetary union. However, there needs to be some capacity for conducting risk sharing. It was pointed out that although currency regimes are likely to be negotiated by the UK and Scottish Governments, the final arbiters will be private investors, and what they decide to do with their own money. If there are two exchange rates, this will be reflected in the foreign exchange markets; if there is a single currency it may happen through credit risk and the ability to raise bond financing. It was observed that under the current payment system, foreign counter-party banks based in London have access to the Bank of England liquidity system. This would presumably be the same for London-based counter-party banks of an independent Scotland. However, it is far from clear that the Bank of England would provide liquidity services to what would effectively be an offshore sterling area with its own regulation. Any shortage of sterling liquidity north of the border might be intermediated by a London-based subsidiary, but the Bank of England would be likely to

require additional collateral to provide liquidity. The point was made that a pre-arrangement may not even be desirable for an independent Scotland. In the event of a crisis, the UK would hold most of the cards on how to impose losses on Scottish institutions. The point was made that with regard to decisions on currency, governments need to ask themselves which choices will be robust in all eventualities.

The unwillingness, in the debate, so far, to talk about the debt that would be transferred from the UK to an independent Scotland, was seen as a big problem. This discussion needs to be in the open and well ahead of the Referendum so that voters know what sort of country and future they are voting for. In conclusion it was suggested that a shared currency between Scotland and the UK would be unstable and capital flight likely to occur. The suggestion was made that with regard to risk management, there has not been adequate understanding of the potential financial risks the day after the Referendum on Scotland's future.

Questions and Answers

An observation was made that the financial sector in Scotland is very large, and that this invited speculation as to whether, as part of negotiations between the UK and Scotland in the event of a 'Yes' vote in the Referendum, London authorities would wish to allow that to continue. It was suggested that the precedent for this might be taken from when HSBC wanted to buy the Midland Bank, at which point they were forced to move their Head Office to London, on the basis that the British authorities did not want a foreign bank with such a large domestic network in the UK. It was suggested that there is a likelihood that the Royal Bank of Scotland (RBS) would be told that if they wish to keep the rest of their operations in the UK they will also have to be headquartered in the rest of the UK, rather than in an independent Scotland. It was therefore suggested that the size of Scotland's financial sector would be resolved in the negotiations following a 'Yes' vote in the Referendum, and the point was made that it might be unlikely that Scotland would be left with a banking sector thirteen times its GDP by the time these negotiations are concluded. In response to this point, it was observed that the question of where a bank is to be headquartered ultimately lies with its shareholders. The shareholders of RBS are, at present, predominantly the British Government, and if the British Government wanted it to be relocated, then that is likely to be what would happen. The prediction was therefore made that, almost immediately after a vote for an independent Scotland, the shareholders of RBS would vote for this bank to relocate its headquarters.

A second point for discussion was raised, namely that there is an assumption being made that during the negotiations following the Referendum, a rational outcome would prevail. It was suggested that this is not necessarily the case. The observation was made that it could even be the case that there were elements of the negotiations which were hostile. It was suggested that there will be elements in the EU which do not wish to see an independent Scotland secede too smoothly, for example Spain. The point was made that not everyone desires a prosperous, independent Scotland as part of the EU as their first objective. Scotland therefore needs to have a fall-back position in the event of a worst-case scenario.

Returning to the point about the potential relocation of RBS, a suggestion was made that the UK Government might not have to do much in order to encourage RBS to relocate. It was also suggested, however, that the assumption that an independent Scotland's financial sector would need to be smaller is not true. The suggestion was made that there are two currency options in which maintaining a large Scottish financial sector could be viable. If Scotland joined the Euro, it is feasible that it could choose to set itself up as a financial sector specialist within the Eurozone. It would also be viable if Scotland were to have its own currency. It was noted that Hong Kong was offered as a good template for this, as a successful small, open economy with a very large financial sector. However, it was also pointed out that Hong Kong has very large foreign exchange reserves and an enormous capacity for government support if needed. Neither would be the case for an independent Scotland. While it would be possible for Scotland to maintain its large financial sector, it would need the monetary and fiscal policy to support this.

Discussion around the size of Scotland's financial sector continued with reference to the estimate that the balance sheet of Scotland's financial sector represents 13 times the size of Scotland's GDP[2]. In reference to this figure, the question was posed as to whether it would be in anybody's interests to have this degree of mismatch post independence. It was suggested that the figure relates to investment banking activity in London, and the question was raised as to whether investment banking activity in London would continue to be allocated to Scotland. The point was made that EU law requires banking headquarters to be in the country of their main activity. It was suggested that in the event of independence, there might be an unwinding of financial registration with regard to where people are located and what they do. The suggestion was made that the current situation, with regard to the size of Scotland's financial sector, has arisen due to the nature of the UK market.

The point was made that the size of the banking system depends upon the fiscal back-stop, which is why Hong Kong and Singapore and many other small countries can afford to have large banking sectors. With regard to the negotiations, it was pointed out that if the UK was to leave the EU before any negotiations with an independent Scotland were concluded, Scotland's whole negotiation with the EU over its own membership would change. It was suggested that the Referendum on Scotland's future is contingent upon the present context, and if this context changes there should be

[2]This estimate was quoted during discussion, and echoes the figure expressed in the UK Government paper 'Scotland Analysis: financial services and banking', which describes the Scottish banking sector as currently accounting for 1254% of Scotland's GDP; close to 13 times its GDP. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/206166/banking_assets_vs_gdp_explanation.pdf

another Referendum. In response to this, it was observed that the greater the possibility of the UK leaving the EU becomes, the easier it will be for Scotland to negotiate membership of the EU on comfortable terms.

Commenting on this discussion, it was suggested that from the EU perspective, the Referendum on Scotland's future is a constitutionally lawful one, and is therefore materially different to the situation with regards to Spain and Catalonia, or to other parts of Europe.

Monetary Policy and Financial Regulation

On the subject of monetary policy and financial regulation, the question was raised as to what would happen to the UK debt in the event of Scotland becoming independent, and what constraints the debt would provide to the development of fiscal policy. Referring to experiences of other countries, it was observed that earlier discussion had suggested that in the case of Ireland, there had been no debt[3] . With reference to Quebec, it was observed that the debt played a very crucial role in the debate before the most recent referendum. It was further suggested that the fiscal constraints on an independent Scottish Government would be considerably tighter than they are under the Scotland Act 2012. The risk would be even greater if negotiations for a monetary union were to fail and Scotland's debt repudiated. This is because the danger of the market pushing up interest rates under these circumstances would be considerable. It was suggested that, on this basis, the risk of the flight of Scottish assets into the rest of the UK would be high, and that to counter this, the Scottish Government would have to run a very tight ship with regard to fiscal policy. Independence therefore implies the need for a tight fiscal policy. It also implies that the interest rate the Scottish Government would have to pay on their share of the debt would be higher than the interest paid by the rest of the UK. The question was posed: how would that affect the rest of the Scottish financial system and Scottish borrowing costs? In answer to this question it was suggested that if RBS and Halifax Bank of Scotland (HBOS) had to relocate to the UK, their borrowing costs would not be affected very much. It was suggested that Scotland's pension funds and asset management would not be affected much, although it was conceded that there might be a possibility that Scottish borrowers became subject to a credit risk, particularly if Scotland had an independent currency. In this instance, interest rates for Scottish borrowers would be much higher. If Scotland took sterling, it was suggested, there would likely be a marginal increase in interest rates, but not enough to make a huge difference.

It was observed that there has been little focus on how the division of the debt would be carried out, and that this question appears to have been far less controversial for the UK than it was for Canada, when Quebec was seeking independence. It was observed that on the subject of UK debt, there is a general acceptance that something like 8.5% of the debt would be acquired by Scotland. Assuming there can be a division of debt, the question was raised as to how the transition to this debt division would be achieved. It was suggested that there are several potential ways of doing this. One possibility is to go into the transition 'cold turkey'; i.e. for Scotland to raise a huge amount of funding at the outset and take over their whole portion of the debt in one go. This strategy was considered to be very risky. Another possibility would be for Scotland to pay its share of all principal repayments and interest rates as it went and to clear the debt gradually that way. A further alternative would be to have a halfway house, whereby Scotland raised as much as it could at the outset to repay the small issues, and kept the large issues to repay as it went.

Concluding this part of the discussion, it was suggested that whatever currency option it took, Scotland's debt would, at least initially until credibility has been established, attract a higher interest rate. In order to keep the higher interest rate within bounds, Scotland would need to have much tighter fiscal policy and, on the assumption that RBS and HBOS would relocate to the rest of the UK, this would account for a marginal negative for the rest of the Scottish financial system.

General Discussion and Summing Up

Fiscal policy, oil revenue, division of debt

A further point about fiscal policy was raised, and this theme was linked with the position of Scotland as an oil exporting country. The point was made that when an economy is dependent upon a volatile sector, such as oil, this creates an additional need for robust fiscal policy. It was observed that this presents a very difficult challenge for a government that is used to running a relaxed fiscal policy, and it was suggested that this difficulty has not yet been sufficiently addressed in discussion or debate around Scotland's future. Commenting on the division of debt in the earlier Czech and Slovak example, it was observed that in this case debt was divided in a 2:1 ratio, with the Czechs taking two-thirds of the debt and the Slovaks taking one-third. This was roughly proportionate to the ratio of the population, not necessarily of GDP. On the fiscal position, it was suggested that, if we look at Scotland as a 'mini UK', Scotland is roughly the same as the UK. Referring to Government Expenditure and Revenue Scotland (GERS) data, it was observed that if oil revenues are excluded, onshore Scottish tax revenues account for around 8.1% of total UK revenues. The GDP share for Scotland, again excluding oil, is around 8.3%. On revenue per capita, then, it was suggested that Scotland generates much the same amount as the UK. On the expenditure side, however, expenditure per capita in Scotland is about 15% to 20% higher than for the rest of the UK, although including oil revenues offsets this. The challenge for any Government will be containing the expenditure side. One position that has

[3]Again, this comment was made during the course of discussion and clarified afterwards; see footnote 1 (page 3).

been put forward is that an independent Scotland would spend less on reserved issues than it currently does, but that only gives limited scope. The challenge then is managing the flow of revenues. It was suggested that the Scottish Government would view North Sea Oil as a positive, because it represents an asset base with a revenue stream, but it does represent a challenge for the Scottish Government. The suggestion was that this is a manageable challenge. The real challenge would be controlling Scottish public expenditure.

Answering this point, it was observed that the Scottish Government is currently talking about using some of the Oil and Gas revenue to create a fund, in order to avoid spending all of this revenue straight away. This was deemed a good approach; however, it was pointed out that the Scottish Government cannot both save those revenues to create a fund and use them to plug the gap between onshore revenue and excess public expenditure, especially if it must also tighten its fiscal policy. There has to be a means of further taxation revenue, and/or cuts in expenditure compared to the present status, in order to deal with the risks presented by the volatility of the oil revenues.

On the subject of Scotland's share of the existing UK debt, it was pointed out that the lack of discussion or even respective positions on this issue was of serious concern. This is particularly the case for the UK, as in the event of a 'Yes' vote, the negotiating position on a share of existing public debt could be significantly weakened. Assuming that the division of debt followed a similar basis to that of the Czech–Slovakia precedent, then an independent Scotland would inherit around 8.5% of the existing UK public sector debt. This is around £85 billion. However, there was some discussion about how this could be done in practice. If the UK accepted an IOU from an independent Scotland, this would be likely to damage its credit standing. It was pointed out that it would be very difficult for an independent Scotland to raise this much finance in the short term. On the topic of negotiations about debt, the question was posed as to whether the Scottish Government would be likely to be open to negotiations about asset sales possibly including the Trident bases. It was also asked whether it is likely that the Government would face pressure from the Scottish people to accept only what they took to be a fair share of the debt, without exchanging this for anything else.

Continuing the discussion on fiscal policy, it was observed that Office for Budget Responsibility (OBR) figures show a UK deficit of around 5% in 2016, the assumption being that Scotland would have a deficit of roughly the same. This deficit would have to be immediately financed post Referendum, in the event of a 'Yes' vote. It was suggested that even if Scotland did not take the 'cold turkey' option of trying to tackle the deficit immediately, there would still be quite a lot of the deficit that had to be financed quite quickly after a 'Yes' vote. It was suggested that this is something which is quite often forgotten.

A point was made that estimates on Scotland's borrowing costs have tended to be based on fairly conservative estimates. It was also observed that, given the magnitude of the debt, each percentage point in credit spread is approximately a percentage point of GDP annually, which represents a lot of money and a big fiscal constraint.

A suggestion was made that UK companies are likely to want to pressure Governments on the costs of decommissioning North Sea Oil, and the question was posed as to whether the Scottish Government has started thinking about that yet. In response it was observed that the Scottish Government has published an Oil and Gas strategy which sets out their framework for dealing with decommissioning.

A point was raised about human capital, and the suggestion put forward that following the Referendum, in the event of a 'Yes' vote, there would likely be a flow of human capital going south.

In response to the points raised under this theme, it was acknowledged that questions about how the debt should be handled would be a key part of any negotiations which took place in the event of a 'Yes' vote. It was observed that small open economies do tend to run tighter fiscal policies, and are subject to greater flows of capital and labour. With regard to how hard or soft the negotiations undertaken by the Scottish Government would be, the suggestion was made that this would depend upon what their mandate was; for example what the percentage of a 'Yes' vote actually was.

Banking and the financial sector

The suggestion was made that the discussion on where banks such as HBOS and RBS might be headquartered has been predicated on a belief that the creditors of the organisation concerned have a call on the taxpayers of the country where the headquarters are located. It was observed that the Scottish Government cannot sensibly accept that proposition. The point was made that there is a need to frame this issue in a wider context than discussions of Scottish independence. A further point was made that, whatever the location of the headquarters, RBS and the Lloyds Banking Group are run out of London, not Edinburgh, and that ought to underpin the discussion. It was suggested that the activities of these banks would not change very much, regardless of the location of their headquarters. Provided the possibility of creating uncertainty about the state of Scottish assets can be avoided, it was suggested that the position of the Scottish financial services sector as an industry is not impacted much by the possibility of independence. It was suggested that the main issue is around what possibility there is for an independent Scotland to engage in regulatory arbitrage and to attract activities to Scotland that are not currently being attracted.

Responding to these points, the suggestion was made that if Scotland took on large financial liabilities and got into trouble, the question is whom it would draw on in the event of needing a bail-out. Would Scotland prefer, under those circumstances, to draw on Brussels or Washington, rather than London? The observation was made that if the UK were to accept a formal currency union with an independent Scotland, it would be London which provided lender-of-last-

resort functions, whereas if it joined the Euro it would be Brussels. If Scotland had its own currency, it would probably be Washington which provided these functions.

The discussion was directed towards what options an independent Scotland would have had in 2008, at the point when RBS and HBOS failed. It was suggested that at this stage there would have been three options for Scotland. The first option would have been the 'Irish option', of Scotland underpinning everything itself. This would have left Scotland permanently in the hands of the IMF and the European Union. The second option would have been to put together a support package for the banks, involving primarily the UK and US Governments, to which Scotland would have made a modest contribution. The third option would have been to deny that the banking failure was a problem for Scottish taxpayers to solve. It was suggested that the only sensible option would have been option two, with clear implications for the UK taxpayers, moving to option three if this did not succeed in the first few days. It was acknowledged that option three would have been a disastrous option for the rest of the world; on the basis that the next country which got into trouble after one country had followed option three would find itself with nobody willing to help out.

A point was raised about the reaction of the markets in the response to the different options available to an independent Scotland. Some suggested that agreement could probably be reached between Scotland and the UK regarding a currency union, if that was regarded as the ideal outcome. The observation was made however, that the challenge is not so much in agreeing a deal 'in principle' as making the deal stick, particularly if there is any perception that the deal is only temporary. The question was therefore posed as to how Scotland might agree and adopt one currency option to begin with, without closing down all other options for the rest of time. The point was made that it might be sensible for Scotland to agree a currency union for the first ten years or so, with the proviso that this might change.

General points

The point was made that Scottish voters voting in the forthcoming Referendum will be doing so in a situation of huge uncertainty, in which they do not have clear knowledge of the costs and benefits of the various potential outcomes. One such uncertainty was provided as an example, this being whether, in the event of Scottish independence, Scottish MPs would be returned in the 2015 UK General Election. If the answer to this is no, this would affect the balance of parties in Westminster and increase the likelihood of there being a UK referendum on Europe.

In response to this point, it was observed that there are two layers of uncertainty in relation to the possibilities for an independent Scotland: economic uncertainty and political uncertainty. The question was asked as to whether voters would benefit from the articulation of a clear economic plan in the lead-up to the Referendum, or whether such a plan is infeasible because of all the political uncertainty. The answer provided was that it is not entirely infeasible to develop a clear economic plan, and that there are certain things we do know about the economic position of an independent Scotland; for example, that it would need to run tighter fiscal policy. It was suggested that there is evidence of a move towards fiscal realism in Scotland, irrespective of the outcome of the Referendum.

On the subject of uncertainty, the Czechoslovakia example was returned to. It was pointed out that in this example, the possibility of a break-up was not a clear option in the election which precipitated it. There was no referendum on the break-up, but rather an election in which it became clear that the two governments had very little common ground. It was questioned whether, in the event of a 'No' vote in the Referendum, the Scottish people would accept the status quo, or whether they would seek greater autonomy in other ways.

It was suggested that the Scottish Government would see the options faced by Scotland as an independent nation as the same, or very similar, to those it would face as part of the UK. It was observed that small, open economies tend to run smaller deficits and less debt, and tend to build up stocks to deal with shocks. It was suggested that there is a lot of work to be done around whether an independent Scotland could build such a reserve, but that this would be the ideal.

At the conclusion of the seminar, the importance of facilitating independent debate on Scotland's constitutional future was emphasised, and the aim of the series, to 'enlighten the constitutional debate', was reiterated. The speakers and participants were thanked for their contributions, and the discussion was drawn to a close.

The seminar series continued with a discussion on Culture and Broadcasting, held in Edinburgh in August.

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