STERLING ALBION

The FUTURE of SCOTLAND and the POUND

If Scotland votes for independence, it should keep sterling but not have a central bank or use the Bank of England as a central bank. Theory and evidence both point in this direction, says LAWRENCE H. WHITE…

On 18th September 2014, Scotland will hold a referendum on whether it should become independent. If voters say "yes", what money should the newly independent Scotland adopt? Should it remain on sterling, switch to the euro, or create a new Scots pound? Alex Salmond, leader of the Scottish National Party, has proposed that Scotland remain on sterling, with the Bank of England continuing as Scotland's central bank, for at least five years.

Today, Scottish currency consists largely of local banknotes that are denominated in pounds sterling and are redeemable for Bank of England notes and token coins. Scotland today can accordingly be described as a "sterlingised" economy with local note-issue.

The Chancellor of the Exchequer, George Osborne, has warned that, in light of recent euro zone sovereign debt crises, London would not wish to enter a monetary union with an independent Scotland that was free to run up excessive sovereign debts for which the (rest of the) UK might feel the need to assume responsibility. But Osborne has not made it clear why monetary union cannot accompany fiscal divorce. Ecuador is on the US dollar standard, but the US government was not compelled to take action when Ecuador defaulted on sovereign debts in 2008, and the event had no repercussions for the US dollar.

RELATIVE TO KEEPING STERLING, A NEW SCOTS POUND WOULD FAIL THE TRANSACTIONS COST TEST, FAIL THE TRANSITIONAL COSTS TEST AND IS UNLIKELY TO BEAT STERLING WHEN INFLATION CREDIBILITY IS COMPARED

Five options and three tests

Ruling out a return to silver or gold, the monetary standards for an independent Scotland to consider are sterling, the euro and a new Scottish fiat currency – let's call it the new Scots pound. Scotland could seek membership of the European Central Bank (ECB) or use the euro independently, as Bulgaria does, without being a member of the ECB. The same choice applies to using sterling. Scotland could use sterling without participating in the Bank of England's policy-making.

Thus there are five options:

- Keeping sterling and participating in the Monetary Policy Committee (MPC).
- Keeping sterling and not participating in the MPC.
- Adopting the euro as a member of the ECB.
- Adopting the euro as a non-member of the ECB.
- Creating a new Scots pound.

Money-using citizens (though not always macro-economic planners) normally prefer a monetary unit that enables a wider range of desired trades and exhibits more stable purchasing power. The first criterion explains why, for example, Latin Americans have widely adopted the US dollar rather than the currency with the best inflation track record, the Swiss Franc. The second criterion explains why Switzerland declines to adopt the euro used by all its immediate neighbours.

This reading of consumer preferences, together with scepticism about the likelihood of successfully using an activist monetary policy to dampen business cycles, suggests a three-part test for any currency offered as a candidate for Scotland's adoption. Firstly, how low are the transaction costs of using it in trade? How high are the transitional costs of adopting it? And how credible is its commitment to low inflation?

An independent new Scottish fiat currency?

A generation ago it was taken for granted that any self-respecting independent nation must have its own currency unit. After the break-up of the Soviet Union, many newly independent countries such as Lithuania launched their own local fiat monies. However, unstable inflation and volatile exchange rates soon led them to reconsider and fix their currencies to the US dollar, the Deutsche Mark or, later, the euro. The nations of the euro zone have all given up monetary nationalism in favour of a transnational currency union.

Applying the transaction-cost test, an independent Scottish currency would clearly require more money-changing when importing and exporting than either the continuation of sterling or the adoption of the euro. Applying the switchover-cost test, transitional costs would clearly be higher from switching to a new currency – either the euro or a new Scots pound - than from remaining on sterling.

The costs of switching to a new Scottish pound could be made somewhat lower than the costs of switching to the euro by setting the new unit's initial value equal to £1 sterling, so that price tags and nominal contracts need not be renumbered at the transition date.

If we apply the inflation credibility test a new Scottish central bank would need a constitutional commitment to low inflation at least as firm as that of the Bank of England or the European Central Bank. If Scotland could produce a really credible commitment to low inflation, so that the inflation credibility test was a draw, the other two tests would become the decisive ones.

With identical inflation rates and credibility, the potential gain to having a uniquely Scottish currency rather than using sterling would be limited to the – likely negligible – benefit gained by targeting the inflation rate within Scotland rather than accepting the inflation rate targeted by the Bank of England for the whole of the current UK including Scotland.

To outweigh the convenience of sharing a common money with the rest of the UK, an independent Scottish central bank would either have to be committed to lower inflation or be more credibly committed to its inflation target than the Bank of England. In other words, it would have to be another Swiss National Bank. This would not be easy to accomplish. If it were easy, then other newly independent countries would have done it.

In sum, the prospects are negligible for the adoption of a new

Scots pound to prove a net boon to Scotland. Relative to sterling it fails the transaction cost test; it fails the transitional costs test; and it is unlikely to beat sterling when inflation credibility is compared.

The alternative of an independent Scottish currency combined with a fixed exchange rate to sterling would deliver the worst of both worlds. It would incur the switchover costs and the inconveniences of money-changing at the border, but provide no better inflation performance than sterling. The risk of devaluation against sterling would hang like a sword over long-term contracts and investments in Scottish pounds, pushing up interest rates.

Sterling or the euro?

Having found the case for an independent Scottish fiat currency weak, we turn to the choice between the sterling standard and the euro standard. Applying the transaction-costs test, we are confronted with the fact that Scotland's trade is much more highly integrated into the UK economy than into the euro zone.

TRANSACTION AND SWITCHOVER COSTS FAVOUR THE USE OF STERLING OVER THE EURO. THE INFLATION CREDIBILITY TEST SLIGHTLY FAVOURS THE EURO, BUT THE GAIN WOULD PROBABLY NOT OUTWEIGH THE OTHER BENEFITS OF KEEPING STERLING

Scotland's 2011 exports to the rest of the UK were £45.5 billion, while its exports to the rest of the EU were £11 billion[1]. This is no doubt largely for reasons of proximity, shared history and common language, factors that will not change with a change in the monetary regime. A sterling standard would thus allow Scotland to avoid money-changing costs for a far larger share of its trade than would a euro standard. Given its current trading (and labour mobility) patterns, Scotland is more naturally a member of the sterling network than of the euro network.

Applying the switchover-costs test, remaining on sterling would entirely avoid the considerable transitional costs involved in switching to a different unit of account. As the countries adopting the euro have found, switching requires sizable one-time costs.

Applying the inflation credibility test, we ask how the two currencies, sterling and the euro, compare with regard to inflation and inflation credibility. Sterling inflation over the last ten years has ranged between 1.1 per cent and 5.2 per cent, with a compound rate over the entire period of 2.7%[2]. Euro inflation has ranged between -0.6% and 4.0%, with a compound rate over the entire period of 2.0 percent[3]. Nominal interest rates on ten-year government bonds have been 40-50 basis points lower in Germany than in the UK[4]. It is difficult to attribute this to anything but the market forecasting lower inflation for the euro over a ten-year horizon. The euro thus appears to have a slight edge in inflation credibility.

To summarise (see Table 1), the transaction and switchover costs favour the use of sterling over the euro. The inflation credibility test slightly favours the euro, but the gain would probably not outweigh the other benefits of keeping sterling. The three tests together favour sterling.

Ranking	Transactions costs	Switching costs	Inflation credibility
1	£sterling	£sterling	Euro
2	Euro	£Scots	£sterling
3	£Scots	Euro	£Scots

Table 1

Scottish participation in monetary policy-making under sterling

Under a sterling standard, monetary policy would be set by the Bank of England. The extent to which

[1]Trade data from the Scottish government's Global Connections Survey 2011 Tables, www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Exports/GCSIntroduction/GCS2011tables

Scotland would participate in setting monetary policy would have to be negotiated. Through a change in the Bank of England's governing statutes, Scotland could be officially represented on the MPC, much as the Federal Reserve Bank of New York has a permanent seat on the Federal Open Market Committee of the US Federal Reserve System. There is no obvious precedent for giving an independent Scotland a seat on the MPC, however, as none of the seats is currently regional.

There is little reason to think that it matters much whether Scotland as such is explicitly represented, however, so long as the Bank of England, in pursuing its inflation target, continues to take Scottish prices into due account. Indeed, if determined by population or national income, Scotland would only have one vote out of nine.

A SCOTTISH COMMERCIAL BANK THAT FAILS TO REDEEM ITS NOTES OR DEPOSITS AT PAR IN STERLING CAN BE SUED. A GOVERNMENT CENTRAL BANK OR CURRENCY BOARD THAT DEVALUES AGAINST STERLING CANNOT

Who would issue currency?

Regardless of whether Scotland has a seat on the MPC, the Bank of England does not need to have any other formal relationship with the Scottish banking system if Scotland continues to be "sterlingised"[5].

Furthermore, an independent Scotland would not need to nationalise the issue of banknotes under any of the three possible monetary standards, just as it does not rely on the Bank of England to issue Scotland's common paper currency today.

Private Scottish banks can continue to issue banknotes, obviating the need for government note-issue either by a central bank or by a currency board. Under a sterling standard, Scottish notes would continue to be payable to the bearer on demand in Bank of England liabilities, although the draconian requirement that they should be backed 100 per cent by Bank of England liabilities (beyond an authorised unbacked issue) – a relic of the British Parliament's Bank Notes (Scotland) Act of 1845 – need no longer apply.

On a euro standard, the continuation of Scottish note-issue would depend on the ECB allowing it as a condition of joining. There is no precedent, as there are no private banknotes elsewhere in Europe, and the ECB might refuse unless its constitution was amended.

There are benefits to depositors and to note-holders, as well as to bank shareholders, from separate Scottish bank notes, to the extent that competition compels banks to offer more interest and higher-quality notes. The earnings from banknote circulation arise from banks using their note liabilities (in addition to their deposit liabilities) to fund productive loans. Currency holding is "intermediated" into capital formation, making the Scottish economy more productive.

Adam Smith praised this aspect of Scottish note-issue in The Wealth of Nations (1776) for contributing to

TIMELINE – FROM INDEPENDENCE TO INDEPENDENCE?

1603 Union of the Crowns: James VI of Scotland becomes also James I of England

1707 Act of Union as the Parliaments of England and Scotland are 'merged'

1708 Abolition of the Scottish Privy Council (effectively the executive branch of the Scottish state)

1716 Expiry of the Bank of Scotland's Charter: thereafter free entry into the banking business

1769 By this point 32 banks in Scotland

1772 Failure of Ayr Bank - only the second ever failure of a note issuing bank in Scotland

1845 By this date 19 note issuing banks with 363 branches

1845 Peel's Bank Act – effectively ends the distinctive Scottish banking and monetary system

1999 Devolution

2014 Independence Referendum

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[2] *Office for National Statistics, Consumer Price Inflation Summary, April 2013.*
[3] *European Central Bank, Harmonised Index of Consumer Prices.*
[4] *OECD Stat.Extracts, Monthly Monetary and Financial Statistics, Long-term Interest Rates series.*

Scotland's rapid economic growth in the eighteenth century. Under a government central banknote monopoly, by contrast, currency holding is intermediated only into government debt.

Should Scotland retain the sterling standard, private banknotes would continue to provide better currency (more reliably redeemable for Bank of England notes or one-pound sterling coins) than currency issued by a new Scottish central bank or currency board. A Scottish commercial bank that fails to redeem its notes or deposits at par in sterling can be sued. A government central bank or currency board that devalues against sterling cannot. The importance of maintaining its reputation in a competitive environment would deter a commercial bank from acting in ways that might endanger its ability to maintain par redemption. A government monopoly faces no such reputational constraint, since its customers have nowhere else to turn.[6]

SHOULD THE POUND STERLING WEAKEN SUBSTANTIALLY IN THE FUTURE, FREE CHOICE IN CURRENCY WOULD ALLOW FOR A SPONTANEOUS TRANSITION TO WHATEVER CURRENCY STANDARD THE PUBLIC THEN PREFERS

Will a Scottish central bank be needed for other purposes?[7]

A co-operative banking institution – an industry association formed by the clearing banks – can best provide the other services that central banks typically provide. Those other services most prominently include payment processing, setting standards for commercial banks and acting as lender of last resort. Central banks that have historically taken on the role of a "bankers' bank" (payment processor) have done so not because they are efficient at it, but because formerly private institutions have been nationalised or legally restricted.

Banking supervision or regulation can be administered by a separate body. An independent Scotland could take greater advantage of the tradition of Scottish banking expertise to become an offshore banking centre for the remaining UK and for the EU, somewhat like Jersey and Guernsey, eliminating inefficient banking regulations.

The scope for efficient regulations is limited to those that are advantageous both to banks and to their customers. Such regulations can be contractually formulated and privately enforced. Bank clearing house associations, such as the body that has today become the Committee of Scottish Bankers, have historically found it useful to develop and to enforce solvency and liquidity standards on their member banks, to assure all the member banks that their clearing partners will not default on inter-bank payments. Clearing house membership then provides a credible "seal of approval" for depositors seeking a safe bank.

A common argument historically for having a national central bank is that it was needed to play the liquidity safety-net role known as the 'lender of last resort'. With Scotland on a sterling standard, however, any solvent Scottish bank can access the market for sterling reserves in London.

A problem remains only if there is a sudden shortage of reserves due to a banking panic. The possibility of panic justifies having a central bank only if it can be shown that panics are more frequent and severe in countries without central banking than in countries with central banking. The evidence actually points the other way.

Canada, for example, had no bank failures in the Great Depression, but did not establish a central bank until 1935. The near-laissez-faire offshore banking plus currency board system of Hong Kong was free of panic in 1997 while the central bank exchange rate systems of Thailand, Malaysia and the Phillipines were speculatively attacked and collapsed. An official lender of last resort can unintentionally worsen the problem of banking panics if it makes explicit or implicit bailout guarantees that encourage banks to take undue risks.

A proposal

An independent Scottish government would best serve its citizens by remaining on sterling for the time being. Representation on the Bank of England's Monetary Policy Committee is not important and Scotland does not have to avail itself of the other central bank services and restrictions of the Bank of England. Scotland should continue to allow local private note-issue, but eliminate the 100 per cent marginal sterling reserve requirement.

Of course, it should allow the public to have bank accounts and currency in euros, dollars or Swiss francs if they wish. Then, should the pound sterling weaken substantially in the future, free choice in currency would allow for a spontaneous transition to whatever currency standard the public then prefers •

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[5] A formal monetary union would be a different matter.

[6]See Selgin and White (2005) and Lawrence H. White and George Selgin, "Why Private Banks and Not Central Banks Should Issue Currency, Especially in Less Developed Countries," The Library of Economics and Liberty Contributors' Forum (19 April 2000) www.econlib.org/library/Features/feature3.html.

[7]This section draws on White (2001).