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SCOTTISH INDEPENDENCE AND CURRENCY: CHOICES, ISSUES AND IMPLICATIONS

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Legal Briefings – By **Paul Butcher and Dorothy Livingston**

During the 2014 referendum, an independent Scotland's approach to currency was one of the most hotly contested issues. That partly reflects currency's role, like flags, as emblems of national identity and continuity. More fundamentally though, different currency regimes have profound implications for a sovereign State's control over its monetary and fiscal policy, access to capital markets, its ability to respond to unforeseen economic shocks and support financial stability. It will also affect the attractiveness of the State to financial businesses and the extent to which it can support a robust financial services sector that participates in international financial markets. See our related briefing on Scottish Independence: implications for financial services.

SCOTTISH GOVERNMENT'S 2014 CURRENCY PROPOSALS: A UK CURRENCY UNION

In the 2014 campaign, the Scottish Government proposed, as set out in its Scotland's Future white paper, that an independent Scotland would continue with sterling as part of a formal monetary union agreed with the continuing UK. Under this proposal, the Bank of England would be accountable to both Scotland and the UK and responsible for monetary policy, macroprudential policy and providing lender of last resort facilities across both countries.

During the campaign, the idea of a Scottish/UK currency union was rejected by all three major UK party leaders, including on the basis that it would not be acceptable to expose UK taxpayers to the pooling of economic, fiscal and financial stability risks with an independent Scotland outside of a political union. Mark Carney, then governor of the Bank of England, in a speech a few days prior to the referendum argued that a well-functioning currency union needed "*tax, revenues and spending flowing across those borders to help equalise, to an extent, some of the inevitable differences*..."

THE SCOTTISH GOVERNMENT'S NEW PROPOSAL: USE STERLING WITHOUT A CURRENCY UNION AND SET UP A REPLACEMENT CURRENCY AS SOON AS PRACTICABLE

In September 2016, the First Minister of Scotland and Leader of the Scottish National Party (**SNP**) established the Sustainable Growth Commission (**SGC**) to recommend policies for an independent Scotland. The SGC's 2018 report proposed that an independent Scotland should keep sterling "for a possibly extended transition period", but with no formal currency union between Scotland and the UK. Depending on the exact details of how this was proposed to be implemented, this would have the advantage of not requiring the formal agreement of the UK as part of wider exit discussions and, with some technical adjustments, Scottish banknotes could continue to be used, as now, as sterling. It also had the advantage of continuity and continued absence of currency transaction cost and exchange rate risk for trade between Scotland and the UK. However, while such an approach may have meant that an independent Scotland would be free from the kinds of formal fiscal constraints that the UK would likely insist on for a formal currency union (if indeed it could be agreed at all), it would mean:

- very limited control of monetary policy, which would in practice substantially be set by the Bank of England on the basis of the requirements of the continuing UK alone; and
- potentially even greater practical fiscal restraints due to having to borrow in a foreign currency.

Such a lack of monetary and fiscal autonomy for an extended period of time following independence was rejected at the SNP conference in April 2019 and an amended version of the SGC's recommendations was adopted with the emphasis shifting to setting up a replacement currency "as soon as practicable"(albeit still with an initial period of unilateral sterling use).

NEW SCOTTISH CURRENCY – REDENOMINATION OF CONTRACTS?

Unlike under the introduction of the Euro within its 19 EU members, there would be no absolute requirement for all contracts to be redenominated into the new Scottish currency (or, in other words, a final fixed conversion rate). The key difference being that sterling would still be in existence after the change with a varying exchange rate to the new Scottish currency (assuming it was not initially fixed).

Indeed, the SGC's report argues that, if a new currency is introduced, the Scottish Government should respect the existing private contracts in place and not seek to "legislate to change the terms of these private contracts."

However, an independent Scotland could pass new legislation redenominating contractual payment obligations which would oblige creditors to accept the new currency in place of sterling. Where it is clear that the parties' intention is for any debt to be sterling denominated, for example, where it is governed by non-Scottish law and a non-Scottish court has jurisdiction or, in some circumstances, where the place of payment is outside Scotland, the relevant court is likely to uphold the choice of law and of sterling as the currency for payment. On the other hand, there may be a higher risk of redenomination for contractual payment obligations governed by Scottish law, where a Scottish Court has jurisdiction, or where the debtor only has assets in Scotland.

Companies may therefore wish to analyse the governing law and also jurisdiction applicable to relevant longer term contracts and also to consider whether contracts should more clearly specify sterling as the currency of account.

A NEW CURRENCY FOR AN INDEPENDENT SCOTLAND

Greater monetary and fiscal flexibility and ability to respond to economic shocks

Introducing a new currency for an independent Scotland would have the advantages of full control over monetary and fiscal policy. In particular, with recent experiences of the financial crisis of 2007-8, the European sovereign debt crisis and now a global pandemic, a Scottish central bank would have the insulation provided against default in the face of severe economic shocks to enable greater support for financial stability as a result of being able to "print money" (ie create central bank reserves), constrained by commitment to price stability. Furthermore, it would allow movements in the exchange rate to support economic adjustments to external shocks; a flexibility which has often been cited as particularly important for an independent Scotland due to the relative importance of fluctuations in oil revenues. Oil is traded in US dollars, so this revenue is also exposed to fluctuations against that currency: so long as the dollar remains strong, this is likely to benefit Scotland in its move to an independent currency. The choices Scotland makes clearly have implications for the solvency of the Scottish Government itself and its access to and cost of borrowing.

Establishing fiscal and central bank credibility vital

That is not to say that adopting its own currency would remove fiscal constraints from an independent Scotland. Indeed, the very existence of access to greater policy flexibility may make investors more wary and add to risk premia. The SGC report is therefore clear that establishing fiscal sustainability and stability of debt issuance (as reflected in price) as well as central bank credibility are crucial for success. Indeed, these are the first two of the six tests, endorsed by the SNP, to be met prior to establishing an independent currency.

The SGC's main recommendations for sustainable public finances, amongst others, include targets for Scotland's public debt to be no more than 50% of GDP and its budget deficit to be reduced below 3% with public spending increases in transition to be "*limited to sufficiently less than money GDP growth to deliver this*". As the box below on *Scotland's underlying fiscal situation* implies, attaining these goals will be challenging.

An independent Scotland could not support its domestic banking system

Given the relative size of Scotland's economy, and even with its own currency, part of maintaining fiscal and central bank credibility would entail avoiding taking full fiscal responsibility for supporting its banking system. Large banks which are currently headquartered in Scotland would be expected to re-domicile to London with large subsidiaries remaining in Scotland. The SGC report to the Scottish Government accepts this.

SCOTLAND'S UNDERLYING FISCAL SITUATION

The 2019-20 position

The August 2020 official Scottish Government figures (Government Expenditure and Revenue Scotland (**GERS**)) for 2019-20 show Scotland's implicit budget deficit, including an illustrative geographical share of North Sea revenue*, was 8.6% of GDP, about 6% higher than the UK as a whole (including Scotland). This is a reflection of higher government spending allocated to Scotland (12% per capita higher than for the UK as a whole) and lower revenues ascribed to Scotland (2.5% lower than for the UK as a whole).

The role of North Sea oil revenue

Scotland's implicit budget deficit, including an illustrative geographical share of oil revenue, has been consistently higher than the UK as a whole since 2012-13 with the gap amounting to between 5-7% a year since 2015-16.

As column (E) in the table below shows, if Scotland's geographic share of North Sea revenue is excluded, Scotland's relative underlying fiscal position compared to the UK has been remarkably consistent over the last 20 years, averaging 7% of GDP higher for three of the five year periods and 6.4% for 2010-2015. For 2019-20 it was 6.9%. This shows how the significant worsening of Scotland's implicit budget deficit during the last five years is broadly attributable to the decline in North Sea oil revenues (see column (D) in the table below).

With the difficulties associated with forecasting future oil revenues the SGC report to the Scottish Government advises that "*oil revenues should be treated as a windfall fiscal bonus*" rather than relied on for maintaining fiscal management. Indeed the SGC report recommends that instead of being used for day to day spending, North Sea revenues should be set aside by an independent Scotland for a new "*Fund for Future Generations*" to invest in Scottish infrastructure and the green economy amongst other things.

	A Average Scottish budget deficit excluding geographic share of North Sea revenue	B Average Scottish budget deficit including geographic share of North Sea revenue*	C Average UK budget deficit	D Average % (A) was higher than (B)	E Average that (A) was higher than (C)	F Average % (B) was higher than (C)
2000-5	8.8%	4%	1.8%	4.8%	7%	2.2%
2005-10	12.3%	5.5%	5.3%	6.8%	7%	0.2%
2010-15	13.3%	8.4%	6.9%	4.9%	6.4%	1.5%
2015-20	9.8%	9%	2.8%	0.8%	7%	6.2%

Figures calculated using Scottish Government figures (Government Expenditure and Revenue Scotland (GERS) 2019-20.

* The GERS figures which include a geographic share of North Sea revenue are illustrative of what the situation might be if Scotland had been independent. For these illustrative purposes, GERS estimate the apportionment of North Sea revenues is based on the median line principle as employed in 1999 to determine the boundary between Scotland and the rest of the UK for fishery demarcation purposes. See also our briefing on: Scottish independence: the international law implications.

Covid-19

In August 2020, the Institute of Fiscal Studies, using the same 2019-20 official GERS figures to project forward using the Office for Budget Responsibility (**OBR**) central reference scenario for public finance scenarios, estimates that, while the pandemic would send the UK's deficit as a whole to almost 19% of GDP for 2020-21 before falling to 4.6% in 2024-25, for Scotland the implicit deficit would be 26% for 2020-21 before falling to 11% in 2024-25.

Since these projections were made, the fiscal outlook for Scotland and the whole of the UK has improved. However, these figures indicate the scale of the borrowing that the UK had to make during the pandemic and the relative impact on Scotland.

Sharing of UK national debt

The headline balance sheet measure the UK uses for its underlying debt-to-GDP ratio is the public sector net debt, excluding the (increasingly large) impact of Bank of England schemes. The OBR's March 2021 fiscal outlook forecast this would peak at 97.1% of GDP in 2023-24.

So, leaving to one side the complexities of the issue (including exactly which liabilities should be divided), how UK national debt is shared is a key question for any exit and future relationship deal negotiated between the Scottish and UK Governments as well as for the sustainability of an independent Scotland's fiscal position.

SOME HISTORICAL EXAMPLES: CURRENCY SPLITS

Great Britain and Ireland

The Saorstát Éireann (the Irish Free State) came into existence on 6 December 1922. Ireland retained Sterling as its currency with no formal agreement with the UK. Notes and coins issued by the Bank of England continued to circulate and be exchanged one-for-one for Irish bank issued notes, which were backed by deposits held at the Bank of England.

It wasn't until 1927 that the "Saorstát pound" or "Free State pound" was established in Ireland. This was pegged 1:1 with Sterling and fully backed by Sterling assets and gold. In 1943, the Irish Central Bank was established. In 1979 Ireland broke the link with Sterling and joined the European Monetary System, and then in 2002, the Eurozone.

Former Czechoslovakia

Czech Republic and Slovakia attempted to retain monetary union on separation, with a plan for it to last at least six months. The lack of credible commitment to a sustainable currency union led to a rush of capital from Slovakia to the Czech Republic as citizens and investors anticipated their deposits being redenominated into a less valuable currency. Monetary union ended just six weeks after its creation in 1993, leading to the creation of two new currencies: the Slovak and the Czech Koruna.

During the 2014 campaign, the Scottish Government argued, in its Scotland's Future white paper, that the sharing of the UK's national debt must be negotiated. Sharing according to historic contributions to public finances or on the basis of population share were given as examples of possible approaches. However, the Scottish Government claimed that any realistic calculation of Scotland's inherited debt should be a "lower proportion of GDP than is the case for the UK as a whole".

At the time, the UK Government took a similar high level position (albeit not in respect to the final part), noting that it would be a matter for negotiation and that "the full spectrum of assets and liabilities – past, future and contingent – would need to be considered" with an independent Scottish State becoming "responsible for a fair and proportionate share".

How would an independent Scotland compensate the UK?

The UK Government makes a further important point emphasising it would not risk defaulting on any debt obligations: "*a share of the outstanding stock of debt instruments that have been issued by the UK would* ***not*** *be transferred to Scotland*". (*emphasis added*).

The SGC report to the Scottish Government picks up on this statement, claiming that "*by definition this means that an independent Scotland would start with zero debt*." It then goes on to recommend that, while a "*fair and proportionate division of assets and liabilities should be negotiated*", all that an independent Scotland should pay to the UK in relation to such division would be debt servicing contributions for the relevant share as part of an "*annual solidarity payment*."

The SGC report's approach, for understandable reasons, ignores the corollary to the UK Government's statement about not transferring debt instruments to Scotland: "*Instead, an independent Scotland would need* ***to raise funds*** *in order to reimburse the continuing UK for this share*." Amongst other concerns that the UK Government might have with the SGC's proposed approach is that by Scotland failing to raise its own debt to pay off its share at the outset, the UK would be exposed to the credit risk of an independent Scotland. (*emphasis added*)

MUST SCOTLAND JOIN THE EURO TO JOIN THE EU?

See our briefing on Scottish independence and EU membership: process and implications for background on this question.

CONCLUSION

HISTORICAL EXAMPLE: ASSETS AND LIABILITY SPLITS
Former Czechoslovakia
In 1993, Czechoslovakia was split into the sovereign States of the Czech Republic and Slovakia. The Czech Republic was the larger State with higher GDP per capita and the central bank and capital markets located in Prague, while Slovakia had greater natural resource reserves. The general principle adopted was for property and natural resources to belong to the State in which it was situated with other non-physical assets and liabilities divided 2:1 to the Czech Republic, in line with the relative population sizes. Debt was divided up on per capita basis.

By dropping its request for the UK Government to agree to a currency union following independence, the Scottish Government has defused the main area of debate regarding currency during the 2014 referendum campaign. However, given the importance of currency to national identity and of currency regimes to the economics and politics of independence, currency (and its related issues) will likely once again be one of the most hotly contested issues in any future referendum.

[More on scottish independence](#)

KEY CONTACTS

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