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Scotland's Currency Options

Jeremy Peat

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I Introduction

This paper has been prepared at the request of Owen Kelly of Scottish Financial Enterprise and Ray Perman of the David Hume Institute. (Until April I was DHI Director and was then replaced by Ray after 9 very enjoyable years in post.)

The request was to prepare a paper setting out the options for Scotland with regard to currency, in the event of a 'yes' vote at September's referendum. This paper attempts to be wholly objective and evidence-based. I have drawn upon a very large number of papers, prepared by UK and Scottish Governments, academics in Scotland, RUK and elsewhere, representatives of the financial sector domestically and internationally and others with an interest in the topic. The number of relevant papers is remarkable. [See the list of references – which in itself is partial.] It is clear that economists and other analysts have found this a topic worthy of their attentions – it has provided employment for their fertile minds for the past year or so and will doubtless continue to do so right up to the 18th September. As one would expect with economists there is no marked degree of unanimity in their views.

In addition to reading these papers, I have had the opportunity to speak with a small number of senior folk from the financial sector in Scotland, arranged by Owen Kelly, in order to achieve a better understanding of the key issues from their perspective and their views on the different options. Also I have given evidence during 2014 to both the Economy and Finance Committees of the Scottish Parliament and studied the evidence given to those committees by various economic luminaries in Scotland and further afield.

As must always be the case with papers such as these, the views expressed are solely mine, and not those of SFE or DHI. Likewise I take all responsibility for all errors and omissions.

II The Options

The choices on the exchange rate front for an independent Scotland can be seen as fourfold, namely: -

1. Continued use of **sterling** via a form currency union
2. Continued use of **sterling informally**, via 'sterlingisation' and/or a possible currency board.
3. Adopting a **new currency**.
4. Moving towards entering the Eurozone and adopting **the Euro**.

There are sub-options within the above.

We should note that a continuing formal currency union has been rejected as an option by the UK Government and spokespersons for Labour and LibDem parties. However, this option is nevertheless seen by many as the preferred choice and is examined below.

There have been suggestions that if the formal currency union were to be ruled out post referendum then 'Plan B' might be a currency board – which is certainly not without its attractions or its drawbacks. A new currency is the preference of some 'yes' campaigners, including some SNP members and Patrick Harvie of the Green party. [Some have called independence with continued use of sterling 'independence –light'.] This currency could be allowed to float freely or it could be tied, loosely or otherwise, to sterling, the dollar, the euro or some basket of currencies.

Adopting the euro would not be an immediate option. This would require Scotland's entry to the EU and then a period (to be determined) during which Scotland met the criteria to be satisfied to permit entry to the euro zone. It is not clear whether Scotland could move from sterling (in some form) to the euro or if an interim period of using its own currency would be required.

III Selection Criteria

A whole host of factors need to be taken into account in considering which of these options and sub-options is 'preferred', from the viewpoints of Scotland and rUK, and there is also, of course, the little matter of which of these options may be achievable.

From an economic perspective¹ the criteria should include the following: -

- Maintaining economic stability through the transition period to independence and beyond.
- Included here would be the preference for many businesses of a continued stable exchange rate with sterling; preference for parity/stability and assurance that this parity/stability would be retained for an extended period.
- Transaction costs associated with each option.
- The extent to which an option would permit the adoption of Scotland-specific macro and micro-economic policies. This includes three considerations monetary policy, over-arching fiscal policy and flexibility on specific tax and other policies.
- If there would not be full freedom on monetary and fiscal policies then is it the expectation that the regime which would apply would be broadly appropriate for the new nation?
- The likely cost of borrowing for Government and corporates – albeit this would also be heavily contingent upon the perception in the markets of (inter alia) the suitability of the new Government's macro policy regime and constraints thereon.

¹ There is an interesting summary of key economic factors by currency option on page R16 of Armstrong and Ebell Feb 2014.

- Achieving and maintaining a competitive exchange rate for the Scottish trading sector.
- Regulation of the financial sector in particular.
- The costs of transition and continued operation of the chosen option.

IV A Continuing Currency Union

1/ Scotland's interests

The first point to stress is that this option would effectively amount to a continuation of the status quo. We are therefore talking about 'a continuing currency union' rather than any new venture. This is of relevance as this is a very different, and much more straightforward, scenario from where two nations might wish to come together to form a new currency union. However, a currency union of 2 sovereign states - albeit ones which previously formed a currency union - with 2 lines of democratic accountability, is very different from the present arrangement.

The key advantages for Scotland are clear. There would be no currency uncertainty or risk of volatility; no transaction costs; and the likelihood of greater stability and reduced uncertainty as compared to the other options.

However, there is also a clear economic downside. There would inevitably be conditions placed upon economic policies for an independent Scotland.

So far as *monetary policy* is concerned, this would be set by a continuing Monetary Policy Committee. Proponents of this option argue that there would be a Scottish member or observer on the MPC. My strong view is that even if this were to be the case, such an individual could not expect to exert more than the merest modicum of influence. I would anticipate that the MPC would be charged formally with the setting of monetary policy on the basis of the key interests of rUK. The committee would take instructions and guidance from the UK Government and/or the Governor of the Bank of England, who again would necessarily be looking at rUK interests alone. The only marginal point to make is that if setting the 'wrong' policy for Scotland could pose risks for rUK, then that might be taken into account.

The question that follows is whether, to what extent and for how long, a monetary policy set for rUK would be in the best interests of Scotland and what costs there might be resulting from sub-optimal monetary policy if and when the economies of the two nations diverge.

Turning to over-arching *fiscal policy*, there has been some debate as to how rigid any 'rules' for Scotland should be. I would suggest that, at the very least, there would be a limit on the level of deficit in any one year (whether in value terms or as some % of GDP) and also on the level of the stock of debt (likewise in £ sterling or as a % of GDP). The extent of the fiscal constraint imposed would inevitably be one major part of any negotiation for a currency union.

There might well also be some constraints imposed on *individual elements of tax policy*. For example, it has been suggested that the government of rUK might wish to prevent an independent Scotland running a corporation tax regime, or other elements of policy towards the corporate sector, which was significantly more generous (less onerous) than that applying in rUK. The argument would be that to permit such policies would be to the disadvantage of rUK, as it might work to attract to Scotland corporate activity which might otherwise be located in England, Wales or Northern Ireland. Again this would be a matter for negotiation and debate.

As stated by the Governor of the Bank of England in his speech in Edinburgh earlier this year: - ‘In short, a durable, successful currency union requires some ceding of national sovereignty.’² The question for negotiations would be (for both Governments) how much ceding of national sovereignty would be involved and (for the Scottish Government) whether this was justified in terms of the other benefits of this option as compared to the alternatives. Again to quote the Governor³: - ‘Decisions that cede sovereignty and limit autonomy are rightly choices for elected governments and involve considerations beyond mere economics. For these considerations, others are better placed to comment.’

Another interesting issue is whether this would be deemed a durable option. In this context a relevant quote comes from the Scottish government’s ‘White Paper’⁴: - ‘It would, of course, be open to people in Scotland to choose a different arrangement in the future’. Such a move, from a currency union to a separate Scottish currency or membership of the euro zone, would certainly be up for possible discussion in the post-independence years. That would be especially the case if the economies of Scotland and rUK were to diverge over time. This could be because Scotland became ‘different’ due to its strength in the oil and gas sector or because policies and priorities between the two economies diverged. It might be the case if, for example, rUK left the EU and Scotland remained an EU member state.

Even the perception that a departure from the currency union was feasible at some time in the future could have an impact on Scotland’s credit status and hence borrowing costs. To cite Professor Young⁵: - ‘... everyone would recognise that Scotland could exit the currency union at some future date. This recognition would have an immediate impact on long-term business decisions. The Scottish Government and all Scottish businesses would face sharply higher international borrowing rates for loans that mature beyond dates at which people feel confident in the currency union being maintained.’

There is a real conundrum here. Ratings agencies and others argue that Scotland’s credit rating as an independent nation would be optimised by being in a currency union. ‘Scotland may retain its credit rating if, for example, it can negotiate a currency union with the UK.’⁶

² Carney 29th January 2014.

³ Carney op cit

⁴ Scottish Government November 2013.

⁵ Young April 2014

⁶ Deutsche Bank May 2014

Also: - ‘the most likely scenario is that Scotland would be rated somewhere in the middle of investment grade, though at least two notches below the UK’s rating. An ‘A’ rating is most likely at the outset, but with risks of a different outcome tilted to the downside. Over time higher ratings [could be] attainable.’⁷

However, Scotland would wish to retain the option to opt out if the balance of the trade-off between stability and no transaction costs on the one hand and the ceding of sovereignty on monetary and fiscal policies was seen as shifting. The answer may be a clear commitment to a currency union on an agreed basis for (say) at least 10 years and a further commitment to provide due notice of consideration of a pending policy change with a commitment to any change being undertaken in an agreed and carefully managed manner.

2/ rUK interests

One immediate advantage of a continuing currency union for the rest of the UK is that there would be no transaction costs in trading with Scotland. This is not as big an issue in this context as it is for Scotland, as rUK trade with Scotland is a much smaller share of overall rUK trade than is the case for Scotland. Professor Muscatelli⁸ estimated the additional transaction costs to rUK of Scotland moving from sterling at between £500million and £2.5billion per year.

There would be a cost to the rUK balance of payments from Scotland ceasing to use sterling, which the Scottish government has estimated at £40billion, but Professor Brian Ashcroft puts at only £3.4billion⁹.

But certainly a continuing currency union would enhance stability through any transition period to independence and also provide stability not just for the trading sector but for businesses across the UK with key relations with Scotland – through the supply chain for example - and indeed parts of their businesses, located in Scotland.

The rating agencies suggest that with a currency union rUK would face a marginal credit down-rating. To cite Moody’s¹⁰: - ‘The most credit-negative scenarios – featuring protracted negotiations and a high degree of uncertainty could result in a two-notch downgrade for the UK.’ If Scotland were allowed into a sterling currency union: ‘this would be credit negative for the rest of the UK, regardless of the institutional arrangements that are put in place.’ ‘Particularly if Scotland was not also subject to binding fiscal coordination and banking union with the remaining UK.’

⁷ Moody’s May 2014.

⁸ Muscatelli April 2014

⁹ Ashcroft April 2014

¹⁰ Moody’s May 2014

It can be argued that a continuing currency union would bring benefits to rUK as well as to Scotland, as compared to the other options. Professor Young has stated: ‘ .. if Scotland chooses independence, then a currency union with rUK would be better for both than Scotland’s other currency options.’¹¹ While Professor John Kay, despite thoughts that sterlingisation might work, still believes that: - ‘An agreed currency union would still be the best outcome for everyone ..’¹² Professor Anton Muscatelli¹³ of Glasgow University has particularly strong views on this issue saying that for rUK to reject a currency union in the event of a yes vote would ‘be tantamount to economic vandalism’.

3/ Could it happen?

The Chancellor of the Exchequer, his Labour shadow and the Lib Dem Chief Secretary to the Treasury have all made very clear their view that the remaining government of the UK would not agree to a currency union in the event of a yes vote in September. There has been a report in the ‘Guardian’ newspaper from an unnamed Cabinet Minister that of course there would be negotiations – and it is presumably best not to rule this option out until the vote has taken place and some political dust has settled.

The Governor of the Bank of England has been somewhat less robust in his statements, as cited above. Much attention has been focussed on the advice letter from the Permanent Secretary at the Treasury to the Chancellor, as published (in itself an unusual event) in the UK Government document analysing the prospect of a currency union.¹⁴ However, it is worth quoting the precise statement by Sir Nick McPherson in that letter: - ‘I would advise strongly against a currency union **as currently advocated**, if Scotland were to vote for independence.’ [My emphasis] Not quite ‘never’!

One of the key issues picked out by former Acting Deputy Governor Brian Quinn¹⁵ and others relates to the banking sector and the inability of Scotland to act as lender of the last resort in such a context – along with the problem of who regulates what across the financial sector.

However, would this be a problem in practice? Would the Scottish banks remain registered in Scotland and subject to regulation in Scotland – with risks falling upon Scottish institutions – in the event of a yes vote and a currency union? One likely outcome is stressed by Professor Young¹⁶ who states: - ‘if rUK accepted a currency union without a tight banking union and tight fiscal rules, then the Scottish banking system would no longer be ‘far too big’, since the part that the Scottish government could not credibly backstop with its fiscal resources would register in the rUK to seek a credible backstop from the Bank of England.’ ‘Indeed, Scotland-registered banks might disappear altogether.’

¹¹ Young op cit

¹² Kay FT April 2014

¹³ Muscatelli op cit

¹⁴ HMG February 2014

¹⁵ Quinn DHI Paper August 2013

¹⁶ Young March 2014

This all suggests that the continuing currency union option is by no means dead and buried. It may make reasonable sense for businesses across rUK, as compared to other options, and perhaps also for the rUK economy as a whole. To many it would appear to be optimal for Scotland and to be potentially feasible. However, this could only be achieved (a) at the cost of yielding significant sovereignty on the monetary and fiscal fronts and (b) if major Scottish banks – and perhaps other financial institutions – relocated to elsewhere in rUK.

It would also be necessary, for rating and other reasons, to commit to such an arrangement for an extended period. As yet the main proponents of a yes vote appear to be wishing to emphasise as much continuity as possible, post their type of independence, but with options wide open. To again cite Professor Young¹⁷: - ‘The Scottish Government was presumably trying to maximise the yes vote by straddling two positions; that an independent Scotland could enjoy the stability of a currency union, yet keep open the possibility of exiting it later to enjoy greater autonomy.’

That straddle may not be sustainable – successfully opting in to a continuing currency union would mean accepting the downside as well as the positive.

V Sterlingisation

1/ Scotland’s interests

This option involves Scotland continuing to use sterling as its currency, presumably via some form of Currency Board, but without any formal agreement with the government of rUK.¹⁸ There are examples of this practice – closest to home we have Jersey, Guernsey and the Isle of Man.

In some ways the benefits of this approach match those of a currency union. There would be no transaction costs but there would be stability – for so long as the arrangement lasted – so far as the exchange rate is concerned. Monetary policy would be set by the Bank of England, and under this option there could be no disputing that the Old Lady would act purely in the interests of rUK paying no attention to any Scottish factors. There would be no question of any Scottish representative on the MPC.

There would be no formal fiscal constraints imposed on Scotland by the rUK Government or the Bank. However, it would be necessary for Scotland to persuade a variety of economic agents that its fiscal policy was suitably robust to ensure that this arrangement could continue.

¹⁷ Young March 2014

¹⁸ There is in theory a difference between informal use of a currency without any arrangement – ‘the Panama option’ and a more formal arrangement via a Currency Board – ‘the Hong Kong option’ – but again with no arrangement with the ‘owner’ of the currency concerned. The pros and cons of each appear similar and hence I have not analysed each separately.

That would be tough. As explained by Young¹⁹: - ‘Under a currency board that pegs the Scottish Pound to Pound Sterling, the Central Bank of Scotland would bind itself to allow the supply of Scottish Pounds (both cash and bank deposits) to change only with currency outflows or inflows that are induced by imbalances in international payments. [leading to] large fluctuations in wages, prices, employment and economic activity as the mechanism for equilibrating the balance of payments.’

Life under this regime would be easier if – as in the case of Hong Kong – very large currency reserves had been built up. Without such reserves, as would be the case for a newly independent Scotland, adjustment of the economy to fluctuations from outside or within would come not via monetary policy, or fiscal policy or a change in the exchange rate but via the real economy. That could prove traumatic.

According to Nomura²⁰ such pressures were sufficient to cause the Argentinian currency board to break in January 2002 ‘when the economic pain of the required real economy adjustment proved politically untenable’. The classic example of the Hong Kong/US \$ currency board survived the pressures at the turn of the millennium, but not without Hong Kong enduring ‘sustained CPI deflation from November 1998 to June 2004.’²¹ Again according to Nomura ‘a Scottish currency board may require a far more aggressive period of fiscal consolidation than would be required under a currency union, a straight currency peg or a floating exchange rate’.²²

Formally Scotland would, as in the currency union, remain responsible for financial stability and financial sector regulation. However, ‘a currency board precludes a lender of last resort’ – hence ‘Countries looking to establish a currency board FZ regime need a strong and well capitalised banking sector’.²³

In the event of banking ‘disaster’ there would be no central bank capability to expand money supply and hence provide emergency liquidity. Faced with this prospect banks would have three choices. First they could boost their own balance sheets in such a way that emergency funding would not be required even in extremis. (Probably unsustainably expensive and prohibiting a competitive sector.) Second they could seek agreement that a foreign central bank – e.g. the Bank of England – would step in as required. (Basically this seems to be an implausible option.) Third they could move their formal base of operations outwith Scotland to a regime where this support would be feasible. (This seems the prudent and likely outcome.)

¹⁹ Young April 2014

²⁰ Nomura February 2014

²¹ Nomura op cit

²² Nomura op cit

²³ Nomura op cit

The risks of the regime failing to hold would be seen as greater than in the case of a continuing currency union with strong commitments on either side. This suggests that the problem of overseeing the financial sector in Scotland would be substantially reduced by the exodus of major elements of that sector to south of the border. Indeed Moody's²⁴ have stated that: - 'the existence of a large Scottish financial services sector probably renders this option unworkable'

Whether it would be both workable and seen as attractive as an option if large chunks of the financial sector disappeared, presumably with an associated extent of capital flight, is a matter of conjecture.

Finally it is worth noting that Scotland's credit rating under this option would be lower than in a currency union and the costs of borrowing for government and other economic agents consequently higher. There must also be a question as to whether continued use of sterling via either sterlingisation or a currency board would be accepted by the EU as an interim status between the present arrangements and entry to the Eurozone.

2/ rUK interests

There would be limited downside for rUK under this option. There would be no question of any responsibility for Scotland's financial sector; no debate over whether Scottish interests should impinge on monetary policy; and no prolonged debate on fiscal rules and possible policy constraints.

At the same time there would be no transaction costs and sustained stability on the exchange rate relationship – albeit with some perceived risks as to how long that could last thereby imposing some risks to be assessed by companies in their cross border relations.

Moody's have indicated²⁵ their view that this option would be: - 'credit neutral for rUK'.

3/ Could it happen?

Many observers see this as a wholly implausible option for an independent Scotland. What might work for the Isle of Man would not necessarily work for an orders of magnitude larger nation such as Scotland. Even John Kay²⁶ admits that: - 'There is no precedent for an advanced country with a sophisticated financial system choosing voluntarily but unilaterally to share another country's money.' While Moody's²⁷ state that: - 'Scotland is at least five times larger than any dollarized, euroised or sterlingised entity.'

²⁴ Moody's op cit

²⁵ Moody's op cit

²⁶ Kay op cit

²⁷ Moody's op cit

The real concerns however must be twofold. First there is the manner in which the Scottish economy would be exposed to the risk of gyrations in the money supply – predominately determined by what happens to the balance of payments, itself sensitive to developments in the international market for oil and gas. With an exogenously determined monetary policy and a strict market watch on fiscal policy the stresses and strains on the domestic economy could well prove unacceptable. Second this option would almost inevitably lead to the departure of the head offices of all major and many minor financial institutions. This could be associated with significant capital flight.

Without much more evidence this option looks dangerous and highly unlikely to be optimal.

VI A New Scottish Currency

1/ Scotland's interests

This option comes in two forms – a new currency pegged to sterling (or conceivably \$ or Euro or some basket of currencies) or one that floats more or less freely and finds its own level in the world markets subject to the odd ‘touch on the tiller’ from the new Scottish central bank.

The pros and cons have been well summarised by Deutsche Bank²⁸: -

– ‘This is the only truly independent option. Scotland would have full control over its monetary (assuming it opts for a floating FZ [foreign currency] regime) and fiscal policy. Its newly created central bank would be able to offer LOLR [lender of last resort] facilities through its ability to print its own currency. But a new currency introduces transaction costs with its largest trading partner (the Continuing UK), it would involve considerable transition costs (the setting up of an independent central bank and the printing and integration of new notes and coins), it raises the possibility of FX shocks rocking the economy (particularly with Scotland being small and open with sizeable exposure to finance and oil) and it would probably mean higher borrowing costs in Scotland’s own new currency than is currently the case in sterling.’

Unpicking the above quotation a little, consider first the advantages of a separate currency. First and foremost there would be no constraints imposed upon the Government of the new nation, so far as monetary and fiscal policy is concerned, by another nation – i.e. the rUK. In that sense Scotland would be free to select such policies as were determined to be in Scotland’s interests.

However, there would be constraints on monetary and fiscal policy. If Scotland determined to peg the new currency to sterling, so as to maintain the benefits of continuing currency stability with her main trading and broader economic partner, then these constraints would be particularly severe. If the new currency were perceived as potentially weaker than sterling, then a tight set of policies would be required to maintain the peg and confidence in the peg.

²⁸ Deutsche Bank op cit

If the Scottish currency were deemed stronger than sterling (for example if oil and gas prices shot up) then alternative means of avoiding excessive inflation – the Norwegian disease – would be required.

The ability to offer lender of the last resort facilities would require careful study. Could this be taken to include facilities to large banks operating globally or just to smaller, Scotland-based and focussed operations?

When Dr David Skilling examined, for the Scottish Government, lessons for Scotland from successful small economies across the globe – of which there are many examples – he did stress that even such established and successful countries tended to require tighter macro policies than their larger counterparts. This particularly applied for countries exposed to the vagaries of volatile and uncertain revenue streams.

The requirement for rigid policies would be less substantial if the new currency were allowed to float freely. But that would be at the cost of exchange rate stability with sterling and imply a risk of volatility with all other currencies. As Professor Young has noted²⁹: -

‘... the UK’s current economic structure was predicated upon a single currency; some of this structure would start unravelling with Scottish independence, since this would introduce long-term uncertainty regarding the rate of exchange of the currencies used in Scotland and rUK.’

Scotland would need time to adjust to this very different economic regime. The financial sector could react to uncertainties by shifting HQs to a more certain and potentially stable location; and capital flight would be a possibility.

There would also be substantial costs – in financial and wider resource terms - in establishing the new central bank, regulatory regimes, tax structures and so much more which would be required under a new ‘own currency’ regime.

In sum, a *currency pegged to sterling* brings continued currency and other stabilities in the relationship with the main economic partner; allows Scotland relative freedom on macro policies (other than as required by the markets); but involves hefty adjustment costs and high risks.

A *freely floating currency* does not provide that stability but may permit more policy flexibility – albeit at the expense of introducing transaction costs in UK trade, etc. It also involves heavy transition costs and is likely to imply a higher cost of borrowing – at least initially – than the other options considered thus far.

2/ rUK interests

The impact on rUK would be limited. The uncertainties mentioned by Professor Young and referred to above for Scotland would apply to rUK, and while no doubt having significant adverse effects these effects would be an order of magnitude less severe than for Scotland.

²⁹ Young April 2014

The rating agencies suggest that ‘an independent currency would all be credit neutral for rUK.’³⁰ And there would be no concerns over sharing monetary policy or being required to agree fiscal constraints on a separate country.

rUK might expect some financial institutions to move south and to anticipate a period of distinct uncertainty and flux. But generally rUK should be able to sit back and watch events unfold.

3/ Could it happen?

There are no evident external constraints on Scotland deciding to adopt this option – nobody else needs to agree! However, given the complexity of the transformation and the multitude of tasks to be undertaken to follow this route, some time would be required if this were to be a smooth process with the minimum of disruption to households and businesses in Scotland.

VII Adopting the Euro

1/ Scotland’s interests

As stated at the outset of this paper, this is not an immediate option but one which might be considered as a medium-term possibility to follow on from either use of sterling or a new Scottish currency as interim measures.

The advantages for Scotland would be that it could ‘piggy-back’ on the credibility of the European currency and the operations of the European Central Bank. There would be currency stability with other nations within the Eurozone, many of them significant trading partners for Scotland and actual/potential sources of foreign investment. Also Scotland’s credit rating would relate to its position within the zone and borrowing costs likely to be lower than with the own currency option – at least for the initial post-independence years.

The financial sector would be regulated by the EU and ECB, and lender of last resort facilities would come from the ECB, with all the strength that that implies.

There would be drawbacks. There would be transaction costs and currency volatility with rUK. There would be no freedom on monetary policy, set by the ECB, and minimal prospects of influencing ECB decisions to take account of Scottish interests. This results in a similar risk of sub-optimal monetary policy as is the case with continued use of sterling and monetary policy set by the Bank of England. However, it could be argued that this risk is greater in the case of policy setting by the ECB. The economies of Scotland and rUK may be deemed more converged than the economies of Scotland and the Eurozone and likely to remain so for an extended period.

Fiscal freedoms could be expected to be very limited. Following the problems in recent years the EU and ECB can be expected to set tight constraints on deficit and debt levels to be achieved to enter the Eurozone and also to remain a participant.

³⁰ Moody’s op cit

There might also be other limitations, for example on freedom to adopt distinct rates of taxation in Scotland. Ireland has a lower rate of corporation tax, but the EU does not approve, would rather that rate rose to the level in other member states and is likely to institute barriers against other nations, particularly new entrants, going down similar paths.

If considering this option no doubt a Scottish government would wish to be secure in a belief that the Eurozone was returned to strength and stability after the woes of recent years; and that the members of the zone constituted trading partners with whom a stable and increasingly important relationship was likely to yield real benefits.

2/ rUK interests

In many ways these are similar to the case of an independent Scottish currency. The relationship with a major trading partner would change markedly, but at least Scottish entry to the Eurozone could be seen as likely to result in stability – and rUK is used to relationships with other Eurozone members. This could all change if rUK were to decide to exit the EU or dramatically change its relationship with the countries of the EU.

There should be no impact on credit rating or borrowing costs.

3/ Could it happen?

The simple answer is probably yes, but not at once and not without a number of conditions being met.

The first requirement would be for Scotland to be a member of the EU. If we simply assume that this condition can be satisfied, then we can rapidly move on to discuss the conditions to be satisfied if Scotland is to join the Eurozone.

The original Maastricht criteria included a debt level of no greater than 60% of GDP and annual deficits of no greater than 3% of GDP – with stable CPI inflation broadly in line with other member states, etc. Some of these conditions were ‘fudged’ in the early years and to many this was one cause of the zone’s problems which emerged as the recession and banking trauma struck. It is deemed likely that the conditions for further entry to the zone will be tightly drawn and rigidly imposed.

There is also a requirement to have a national central bank and a track record for a number of years sufficient to establish credibility and justify Eurozone entry and participation. This track record would likely have to be established post-independence, possibly including a period of continuing use of sterling in one form or other and certainly including any period of operating a distinct currency.

It is not possible at this stage to estimate the length of time it would take to proceed from independence to Eurozone entry, even if this flight path were to be agreed as desirable post referendum. Consequently, and given the attitude at present of the Scottish government, this may appear a remote possibility at this stage. That may be correct, but given the costs and uncertainties associated with each of the other options the Eurozone possibility should not be excluded at this juncture. In the fullness of time it might even appear desirable for a small independent nation – as was indeed perceived to be the case pre-crisis.

VIII To Conclude

There is no simple and obvious preferred choice for a Scottish currency post-independence.

The continuing currency union ticks many boxes, but may not be achievable and if implemented would involve no independence on monetary policy and significant constraints on fiscal policy. Would this be widely accepted as a long-term arrangement?

Sterlingisation or a currency board would in principle deliver currency stability and no transaction costs, but the practical difficulties and risks look too many and too great to make this an attractive proposition.

Adopting a new currency pegged to sterling again has many attractions in terms of continuity and stability, but would involve severe constraints from the markets on monetary and fiscal policy and the probable loss – as with sterlingisation – of large chunks of the Scottish financial sector.

A new freely-floating currency would mean loss of that stable exchange rate and wider economic stability with rUK; and uncertainties for many in Scotland but could deliver policy flexibility – subject to meeting market requirements to ensure that volatility was not excessive.

Adopting the euro may prove an attractive proposition in the medium or longer term but is not available as an instant option, and would certainly not be readily and rapidly achieved or cost free.

Overall the continuing currency union looks the preferred choice if it can be achieved. If not then a new currency may be necessary, perhaps alongside a commitment to aim at entry to the Eurozone within some scheduled time period.

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