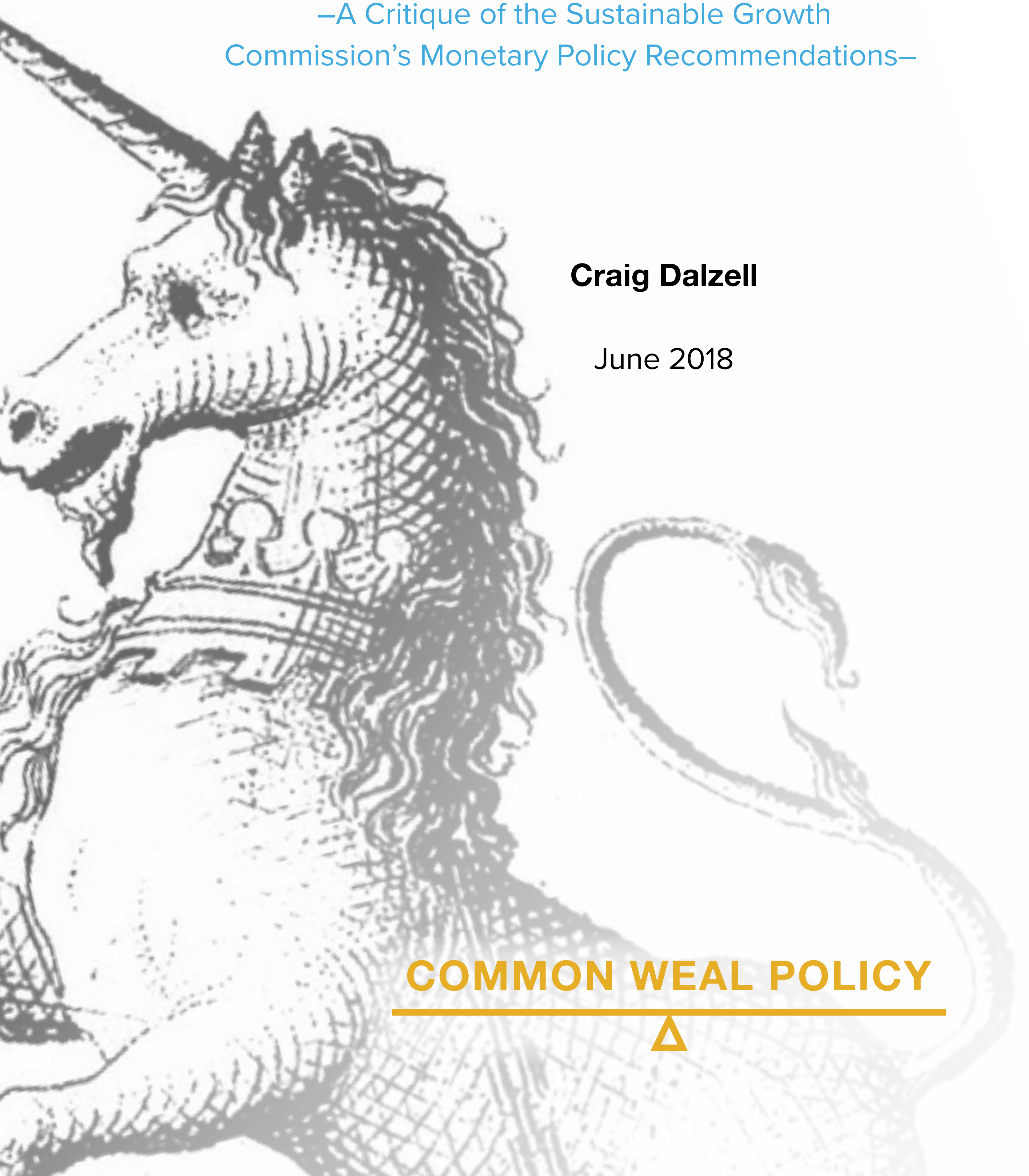
A Silver Chain

–A Critique of the Sustainable Growth Commission's Monetary Policy Recommendations–



Craig Dalzell

June 2018

COMMON WEAL POLICY

COMMON WEAL is a think-and-do tank that advocates policies that put **All of Us First**. For more information on Common Weal Policy visit allofusfirst.org/policy or email craig@common.scot

Author

Dr Craig Dalzell is the Head of Policy and Research at Common Weal.

He runs a politics and economics blog at **thecommongreen.scot**

Contents

Introduction

On the 25th May 2018, after more than 18 months of preparation, the SNP-commissioned Sustainable Growth Commission made its final report – entitled Scotland – The New Case For Optimism – which has been presented as a series of recommendations on which could rest the economic, fiscal and monetary case for Scottish independence in a future referendum campaign. This document does not cover the full gamut of policies which would be directly affected by independence nor does it cover the full range of institution building required by a nascent independent state. Whilst the report discusses the creation of a "Central Bank" and associated regulatory body the discussion about the creation of other institutions such as energy regulators, customs and borders agencies and foreign and diplomatic services lay outwith its remit.

For these reasons the report has been presented as a "discussion document" which will be presented to SNP members and the wider "Yes movement" of pro-independence groups and activists over the summer of 2018 in a series of National Assemblies. The proposal is that the discussions which take place at these assemblies will inform the SNP's view of the Growth Commission's report and shall guide the formation of the SNP's eventual proposals for policies regarding an independent Scotland.

Naturally, almost every group who critically analyse the Growth Commission's report will find aspects with which they agree and others with which they disagree. Common Weal is no exception in this regard. We find areas to agree with in the report particularly around points which appear to have been heavily influenced by Common Weal's own research such as the methodology employed to calculate post-independence finances[1], the calculation of debt and asset negotiations[2] and the principles which should underpin a Scottish tax system.[3]

However, we have taken particular exception with the proposal for currency and their implications for the monetary and fiscal policy of an independent Scotland in both the short and long term.

Common Weal have invested a great deal of time and resource into the topic of currency in an independent Scotland and were the first group to publish thoughts on currency which took into account the "material change in circumstances" presented by the UK's decision to leave the European Union. Our collected work to date covers Scotland's viable currency options[4], the process involved in creating a new currency[5], the tools at Scotland's disposal to ensure sufficient foreign exchange reserves[6] and the principles by which to build a Scottish Central Bank[7] and shall include future work regarding issues such as payments systems and other aspects of monetary infrastructure.

Whilst the purpose of this report is to specifically critique the report produced by the Growth Commission it is done so in the spirit of the principle laid out by the First Minister on the latter's publication. If the Growth Commission report was produced to be discussed, then this report seeks to add to that discussion by highlighting what we see as the shortcomings of its findings and how they can be corrected.

Currency and the 2014 Independence Referendum

In 2013, the Fiscal Commission Working Group[8] published its recommendations on the currency position which was to agree a formal currency union with there remainder of the United Kingdom. This would become the favoured position of the primary pro-independence campaign into the 2014 independence referendum. This position came under severe scrutiny during the campaign, not least because it was a position that required the mutual consent of a UK government which had a vested interest in not granting that consent for political reasons despite any economic

1 C Dalzell, "Beyond GERS", Common Weal, November, (2016)

2 C Dalzell, "Claiming Scotland's Assets", Common Weal, September, (2016)

3 R Murphy, "A Scottish Tax System: Imagining the Future", Common Weal, August, (2017)

4 C Dalzell, "Scotland's Currency Options Post-Brexit", Common Weal, July (2016)

5 P Ryan, "How To Make a Currency: A Practical Guide", Common Weal, January, (2017)

6 P Ryan, "Backing Scotland's Currency – Foreign Exchange Reserves in an Independent Scotland", Common Weal, June, (2017)

7 C Dalzell, "Scotland's National Bank – Central Banking in an Independent Scotland", Common Weal, November, (2017)

8 Fiscal Commission Working Group, "First Report – Annex: Assessment of Key Currency Options", February, (2013)

incentive to do so and despite any likelihood of that position changing after the referendum result and the heat of the campaign.

It is almost a "received wisdom" that the currency policy choice became a liability for the pro-independence campaign, particularly after George Osborne ruled out a currency union and after Alex Salmond struggled to articulate a "Plan B" during a live television debate with Alistair Darling. This interpretation has been challenged by Prof. Sir John Curtice who has pointed out[9] that whilst attitudes towards economic factors were a very strong indicator of voting intention (92% of people who thought the Scottish economy would be better as a result of independence voted "Yes". Just 6% of those who thought that independence would worsen the economy voted "Yes") the question of currency itself was rather more muted. There appeared to have been a calculated risk on behalf of the pro-Union campaign in announcing a veto on currency union as telling the electorate that they cannot have something that they want could well lead to voters concluding that the side wielding the veto was not acting in their interest. Prof Curtice notes that the two periods noted above when the currency debate was at its most intense coincided with periods of substantial shifts in the polling in favour of the pro-independence campaign.

For those who remained negative about currency, it appears that the issue became a touchstone by which they could easily articulate fears about the economy in general and the lack of a coherent response from the pro-independence campaign served to strengthen the fears that if the potential government of independence couldn't be trusted on currency then it couldn't be trusted to adequately manage the economy as a whole.

The Sustainable Growth Commission's Recommendations

Since the 2014 referendum, the circumstances underpinning the independence campaign have significantly changed. There is now desire to avoid handing the opposition party a veto which could be used or threatened with use (no matter the facts of the agreement) is considered prudent campaigning strategy. More fundamentally, the merits of a currency union (such as they were – Common Weal have always advocated an independent Scottish currency) have been undermined by the fact of Brexit. It is difficult now to see a circumstance whereby Scotland could be a member of the EU whilst also being a minority member of a currency union with a country that has recently left the EU. Even if such a thing is legally possible, the politics of the decision may prove intractable. For these reasons, the Growth Commission has re-examined the issue of currency and has presented a different set of recommendations based on Scotland continuing to use the UK pound Sterling without mutual agreement or union – a process often known as Sterlingisation.[10]

The proposal would involve setting up a small, limited monetary institute – branded as a Scottish Central Bank (SCB) though with greatly curtailed powers compared to a full central bank and with only around a third of the budget compared to the typical central bank for a country the size of Scotland – and its associated regulatory body which would, again, be significantly limited as most of the financial regulatory role would be determined by UK policy. Indeed, the Growth Commision proposes to simply copy wholesale the body of UK financial regulatory code – with all of its limits, failures and loopholes – directly into the new regulator without taking the opportunity of independence to correct many of the issues readily apparent.

This SCB would have the responsibility of acting as the Scottish government's bank (managing its financial transactions and issuing bonds), regulating the Scottish financial industry, providing liquidity and clearing operations for said industry and may provide statistical services related to finance and the economy. Without full monetary powers or an independent currency, the SCB would not be able to set interest rates, directly create money or set targets on metrics such as inflation or balance of trade. Monetary issue and volume would be controlled by buying and selling Sterling on the currency market and Scotland would technically have full control over fiscal policy (the setting of taxes and spending policies).

The Growth Commission takes the position that this Sterlingisation process would not be time limited in nature though it does suggest that a Scottish currency could eventually be created at a later time. It lays out "six tests" which would have to be met before it could recommend that a future Scottish Government should begin the process of creating a Scottish currency.

1. **FISCAL SUSTAINABILITY –** The Scottish Government

9 J Curtice, "Does The SNP's 'Growth Commission' Matter?", What Scotland Thinks, 24th May, (2018)

10 The Growth Commission objects to the term Sterlingisation on the grounds that it implies a process of abandoning a country's currency in favour of adopting Sterling whereas Scotland already uses Sterling at present. This semantic issue is of little consequence given that the final monetary policy scenario would be the same in either case.

must have met targets surrounding fiscal position set by the Growth Commission, including achieving a fiscal deficit of less than 3% of GDP and a debt ceiling of less than 50% of GDP.

2. **Central Bank credibility and stability of debt issuance –** The price of Scottish debt issuance and the stability of those prices must show evidence that Scotland has developed sufficient international and market credibility.

3. **Financial Requirements –** A separate currency must better meet the needs of Scottish residents and businesses in terms of financial arrangements than the Sterlingisation process.

4. **Sufficiency of foreign reserves –** Scotland must have sufficient foreign reserves to allow currency management.

5. **Fitness to trade and investment –** A separate currency must better reflect Scotland's trading and investment requirements.

6. **Correlation to economic cycles –** Linking one's currency to another country works best when the economic cycles of both countries are in phase. If this delinks (i.e. if the UK suffers an economic slump whilst Scotland's economy is growing) then a separate currency and independent monetary policy may become desirable.

To be clear, despite reporting to the contrary and despite informal opinion that the Sterlingisation process could last for around or up to ten years, there is no proposal for a timeline within the Growth Commission's report. Nor is there any requirement that the Scottish Government must actively seek to meet these – sometimes arbitrary – targets. This recommendation is not a process that will inevitably lead to an independent Scotland launching its own currency. Indeed, the process of the "six tests" may be seen as much as a barrier to change as a target to achieve it. This is analogous to Gordon Brown's "five economic tests" which acted as a plausible and politically palatable block to the UK's attempt to join the Eurozone as that currency union was launched in the late 1990s.

Further, the six tests presented here may well act to actively prevent the creation of a Scottish currency by means outlined in the following section.

What would be needed for Sterlingisation to Work?

To be clear, currency substitution processes such as Sterlingisation are in use in various countries around the world and have been used to greater or lesser success for years or decades. However, all of the countries involved – such as Ecuador with respect to the US dollar, Montenegro to the euro or Liechtenstein to the Swiss franc – have very small economies compared to the currency zone they are informally part of. None of the countries mentioned above have economies of more than about 1% the GDP of the overall currency zone. As of 2017, Scotland's GDP is about 8.2% of the GDP of the UK.

This is critical to understand. As part of a unitary state, the Scottish government has no control over the monetary policy of Scotland but the Bank of England has a responsibility to consider the economy of Scotland when making decisions over interest rates or other monetary policy tools. As part of a formal currency union such as the one proposed in 2014, Scotland would have gained a formal permanent representative on the Bank of England's Monetary Policy Committee – just one vote in ten, but that representation may have provided sage advice when required. Under Sterlingisation, not only would Scotland have no representation but the Bank of England would be under no obligation to consider the economy of Scotland when making decisions nor would it even have the formal duty to advise the Scottish Government on potential policies which could aid monetary policies. To remove such a large proportion of a currency zone from policy decision-making is unprecedented in modern monetary history and may well lead to severe instabilities both foreseen and unforeseen.

There is a more direct impact of removing monetary policy decisions from Scotland. Without the ability to print money and control monetary volume via methods like Quantitative Easing, the SCB – the Scottish monetary institute – would be forced to apply different methods of ensuring that there was enough money in the Scottish economy at any given moment. This is important as failure to do so can result in a liquidity crisis.

Without direct printing, there would be essentially three methods of injecting Sterling into a Sterlingised economy.

1. If there is a natural trade surplus between Scotland and the rest of the Sterling zone (i.e. the rest of the UK) then there would be a natural tendency for more Sterling to flow into Scotland than flows out.

2. If there is a trade surplus between Scotland and the rest of the world, foreign currencies such as the euro and dollar would accumulate in Scotland which could be sold on the market or swapped with other central banks for Sterling.

3. The Scottish government could issue bonds denominated in Sterling (or any other currency which could then be sold or swapped for Sterling).

Previous research[11] by Common Weal has shown that Scotland's trade statistics – particularly those regarding trade with the rest of the UK – are insufficient for current policy needs and certainly insufficient for determining foundational monetary policy so it is difficult to impossible to determine if conditions 1 or 2 would be met on a consistent basis. Even if sufficiently rigorous statistics for the current state of Scotland were published then these would not serve as reliable indicators for the situation post-independence. Effects such as the impact of the border between Scotland and England (which is likely to end up no "softer" than but no "harder" than the border between Ireland and Northern Ireland), the effect on trade in goods and services across that border and the eventual impact of Brexit and the resulting withdrawal and trade deals may be substantial.

In the absence of trade surpluses, the only other source of additional Sterling (either to enable to grow the Scottish economy or simply to replace that lost through any trade deficits) the Scottish Government would have to borrow money. Without the ability to set base interest rates, the Scottish government would be forced to borrow money at a rate based on the Bank of England's base rate but with an additional premium set by those willing to loan the money – chief amongst them would almost certainly be the financial industries of London. Experience of other countries which have placed themselves at the mercies of markets which, ultimately, look to their own profit lines and shareholders first and foremost. Whilst in normal circumstances the premium applied by the market would be expected to be relatively low in absolute terms (<1%), this premium represents a very high rate in relative terms in the current world of historically low base rates. An independent Scotland borrowing money at 1.5% would be paying three times as much interest as a UK Government borrowing the same amount of money at the present Bank of England base rate of 0.5%.

The private financial industry may also seek to apply conditions to loans beyond the interest rate premium. It is not uncommon for there to be demands such as the mandatory selling off of public assets or the opening of public companies (such as utilities and healthcare) to private competition or takeover. This leads to a double-shock as the selling off of assets to service loans or as a condition of them reduces the avenues for public revenue which makes it harder to service the loans.

This set of circumstances could be made substantially worse if an economic shock resulted in Scotland being forced to apply to international bodies such as the IMF for emergency funding as they have a history of applying very severe fiscal conditions[12] on countries such as demands for even tighter Austerity and cuts to public sector wage bills (which can cause extreme damage to the economy as spending contracts and social security costs rise)[13]. Analogies between the prospective economy of an independent Scotland and that of the economic damage deliberately inflicted on Greece by financial and political institutions are perhaps over-used during the Scottish constitutional debate but in this instance they are most certainly not unwarranted.

Finally, these scenarios are predicated on the ability of the London financial markets to loan Scotland the money in the first place. If another financial crisis similar in magnitude to the one which occurred in 2008 happened again then London markets may themselves suffer a liquidity crisis which would prevent them loaning money to Scotland at any price and regardless of the soundness of the Scottish economy and how well it was otherwise insulated from the crisis. In this scenario, even if Scotland maintained a substantial trade surplus it would be vulnerable in the same was that countries like Jamaica – whose stringent financial regulations prevented bank collapses in 2008 – suffered as the global tourism industry collapsed in the wake of the crises elsewhere.

In order for Sterlingisation to be a successful policy long term, both Scotland and the rest of the UK must run economies which do not threaten to become systemic risks to the other, Scotland must maintain a trade surplus – particularly with the Sterling zone – which outweighs any government fiscal surplus (which would act to take money out of the economy). In order for this particular Sterlingisation plan to meet the "six tests" and result in a Scottish currency is itself worth scrutinising.

A Silver Chain Around Monetary (and Fiscal) Policy

The "six tests" have been presented as a measure which must be met before Scotland launches its own currency but, as stated above, these "lists of tests" are more often set up as barriers than as targets. The analogy with Gordon Brown's experience with the euro is a pertinent one. More damaging to the case for an independent Scottish currency

11 C Dalzell, "Scotland's Data Desert", Common Weal, February, (2018)

12 S J Rickard, "International Demands for Austerity: Examining the Impact of the IMP on the Public Sector", Review of International Organizations, January, (2018)

13 C Dalzell, "Beyond GERS", Common Weal, November, (2016)

is the possibility that the tests presented in the Growth Commission would act against the act of creating one.

1. Fiscal sustainability

The relationship that governments have with their national debt is entirely dependent on whether or not they have monetary sovereignty. Countries which can print their own currency cannot inadvertently go bankrupt in or suffer a liquidity crisis of that currency. Additionally, with control over monetary policy, Scotland would be able to mitigate the impact of debt interest payments on government finances by adjusting interest rates or by using Quantitative Easing to sterilise (Interest paid by the UK Government on debt owned by the Bank of England is paid back to the UK Government as profits) or to outright write off debt. This is not possible in a Sterlingised Scotland.

The setting of an arbitrary deficit target may be directly in conflict with other policies. If Scotland had an overall trade deficit of 3% of GDP then 3% of GDP worth of Scotland's money would flow out of Scotland each year. This would have to be replaced by a Government deficit or a private sector deficit equalling this amount (or exceeding that amount if GDP growth is also targeted as a policy).

If the Government deficit is constrained and the ability to print money blocked then the private deficit MUST therefore increase. The Growth Commission's report makes detailed comment of the unsustainably of the UK's consumer credit economy. This fiscal target combined with Sterlingisation would result in this very kind of consumer credit bubble and this would be one that the Scottish Government would be unable to bail out via QE when (not if) the bubble inevitably burst.

2. Central Bank credibility and stability of debt issuance

The monetary institute proposed by the Growth Commission would not be a Central Bank – despite the branding exercise. Whilst it may well be able to develop credibility in the areas within its remit, it could not possibly develop credibility in the areas outwith that remit so if there is any uncertainty in how it operates this would remain until it takes on those additional roles. The fact that Scotland would not have a full central bank may have implications for other policies and decisions such as the one to join the European Union. Montenegro is an example of a country which does not have its own currency and yet is progressing through the process of joining the European Union. Its progress towards meeting Chapter 17 of the Aquis Communitaire (the common EU rules to which all members and prospective members must apply) was stated in the 2018 report as "moderately prepared"[14] with its lack of monetary policy powers specifically highlighted. However, it should be repeated that Montenegro unilaterally uses the euro – the currency of the political union that it intends to join and thus the union which ultimately controls that currency. The fact of Brexit will be that an independent Scotland which sought to join the EU may be attempting to join a political union whilst unilaterally using a currency controlled by a country which has recently left the EU. Depending on the politics of the UK's departure and how "hard" the Brexit becomes, this may not be taken as a positive sign with respect to the SCB's credibility.

3. Financial Requirements

As stated in the analysis of test 1, the fact of Sterlingisation coupled with a substantial trade deficit and constrained public finances may result in a private credit bubble or outright liquidity crisis within the private sector of Scotland. One of the motives for remaining with the Sterling is for the purposes of continuity with respect to ongoing liabilities such as mortgages. In practice, laws like the Mortgage Credit Directive (an EU law written into UK law in 2015 and thus already solidified regardless of the ongoing Brexit Withdrawal Bill) compels banks to offer foreign exchange risk mitigation for people who have mortgages denominated in a currency which is not that of their income or place of residency. This includes measures up to and including outright re-denomination of the liabilities. Sterlingisation would, however, maintain an active and systemic risk to the Scottish economy in the form of the UK's financial regulation policies – which proved entirely insufficient to protect the UK from the 2008 Financial Crisis and have not improved greatly since. Sterlingisation would act to prevent Scotland from shaping its regulatory policies to prevent a crash which affected the UK from harming Scotland as well.

On a policy level, Scottish consumers and businesses will be affected by interest rates and other decisions taken by the Bank of England which may actively exclude their interests from the decisions. Should the Bank of England raise rates to calm an overheating London economy whilst Scotland is in a downturn (or vice versa), then the decision may actively harm the Scottish economy. Without formal representation within the Bank of England or monetary policy in its own right, Scotland would have to rely on fiscal powers (such as raising and lowering taxes) to simulate the same effect. Thus far from having "full" fiscal control, the lack of monetary powers places firm restraints on Scotland's ability to exercise sovereignty in these areas too.

4. Sufficiency of foreign reserves

The question of foreign reserve sufficiency is an active area of research within financial circles. Old, pre-2008, advice stated that mature economies would not require more reserves than were required to pay for three months worth

14 European Commission, "Montenegro 2018 Report", Commission Staff Working Document, April, (2018)

of imports into the country. This advice has proven to be insufficient and far too simplistic. Current advice[15] is more nuanced and states that multiple factors such as underlying policy and economic fundamentals and regulatory positions have an impact on the level of foreign reserves deemed to be sufficient. One example of this would be a policy which demanded that retail and investment banks severely limit their exposure to risk and maintain adequate capital reserves in their own rights. This would limit the frequency and severity of banking crises and could mean that banks could protect themselves without resorting to the central bank – which means the central bank would not need to hold as much in reserve as would otherwise be the case.

However, this more nuanced view must accept that the level of reserves deemed adequate for a Sterlingised Scotland may differ from the level deemed sufficient to back an independent Scottish currency. This paper makes no statement on where those two levels would be but if it was the case that an independent currency required more reserves than needed for Sterlingisation then the act of Sterlingisation would be a barrier to creating an independent currency. Oversaving is as much of an issue to the economy as undersaving as it draws money out of the economy that could otherwise be spent or invested. If the Sterlingisation process recommended in the paper required substantially more reserves than a Scottish currency would then there may be a risk involved in responsibly drawing down the reserves in such a way that it did not disrupt the market or the economy by flooding sectors with money. Finally, as noted by the IMF, the requirements for adequate foreign reserves are not simply a matter of sufficient money as the calculations are based on the requirements which may or may not be different under different currency schemes and tools which can be used to manipulate the adequacy level (such as capital requirements on banks) may or may not be available under Sterlingisation compared to under a fully independent currency regime.

The creation of the foreign exchange reserves also differs significantly between the two currency regimes. If Scotland follows the plan laid out by Common Weal[16, 17], for an independent currency set up at the point of independence then the reserves can be built using a combination of tools such as acquiring a share of the UK's foreign reserves as part of the debt and asset negotiations, creating Scottish currency and swapping them with central banks who represent countries which wish to trade with Scotland (primarily the Bank of England) and issuing foreign currency bonds (chiefly Euro bonds). Under the Sterlinisation plan, many of these tools become unusable (in the case of the currency swap – as Scotland would have nothing to swap with) or much more risky and expensive to use (in the case of the bond issue). Additionally, the claim on the UK's foreign reserves is a tool which can only be used at the point of independence. Scotland could not settle the "exit deal" and then approach the UK ten or more years later and request its "share" of reserves when we are ready to adopt an independent currency. This would leave the Sterlingisation plan with having to try to build foreign reserves by creating trade or fiscal surpluses and diverting some of that money to the reserve account. But as with the case of the fiscal restraint program, this equation would only balance by applying either a suppressing effect on Scottish economic growth or by adding an upwards pressure on the level of private debt.

5. Fitness to trade and investment

As the Growth Commission report takes pains to state, Brexit is a "clear and present danger" to the Scottish economy. The Sterling fell substantially against both the euro and the US dollar in the days after the 2016 EU referendum and whilst it has regained some of its relative value against the dollar (chiefly due to a drop in the value of the dollar than due to a rise in strength of the Sterling) it has remained towards the lowest end of its ten year range against the euro.

A great deal of uncertainty still lies around what form Brexit will take and how it will impact the UK economy but with a severe mismatch between UK Government rhetoric ("The UK will be leaving the customs union") and its actions (no action has yet been taken to upgrade port and border infrastructure to deal with the consequences of leaving the Customs Union). This mismatch significantly increases the chances of the UK being unable to successfully negotiate a stable deal with the EU on withdrawal and then its trading relationship afterwards. It may be that the UK simply ends up "crashing out" of the Brexit process without any negotiated deal which will have dire but unpredictable consequences for the UK's trading environment for years to come. Even in the best case scenarios, there are no serious projections which lead to the UK being better off than it would have been had it not left the EU.

One of the failings of the UK economy, correctly identified by the Growth Commission, is the extreme regional inequality in the UK. No other country in Europe comes close to matching the parasitic hold that London and the South East have over the country as a whole. UK investment decisions are too often driven entirely by how those decisions would affect London. As a case in point, it has been observed that the effect of the HS2 rail link will not be to bring jobs from London to Manchester but would simply act to bring Manchester into commuting distance of London. The fact that Scotland could not easily be brought into such a radius is almost certainly a key factor in the delays in plans to extend the line north of the border and why the project itself is going ahead despite evidence that

15 IMF, "Guidance Note on the Assessment of Reserve Adequacy and Related Considerations", June, (2016)

16 P Ryan, "Backing Scotland's Currency – Foreign Exchange Reserves in an Independent Scotland", Common Weal, June, (2017)

17 Common Weal, "How to Start a New Country", Common Print, February, (2018)

it will actively harm the Scottish economy.[18]

As stated previously, a Sterlingised Scotland would be almost entirely beholden to the London financial markets for its monetary policy and it is inevitable that this will affect fiscal and trade policy as well. The London markets would not look kindly upon any kind of independent Scottish trade or investment deal which did not benefit them or would act to harm them. The significant risk of a liquidity crisis will also act to encourage the Scottish government to be risk-averse to the point of conservatism. Significantly, the uncertainty caused by the fact that a Sterlingised Scotland might one day launch its own currency would only increase the aversion to risk. Investors may be very unwilling to sign long-term contracts which may have to be re-negotiated or re-denominated at some unknown point in the future. This test would therefore not be met by virtue of trying to meet it – an obvious contradiction and one which would be sufficient to lock Scotland into Sterlingisation not just indefinitely, but permanently.

6. Correlation to economic cycles

One of the opportunities of independence – as identified correctly by the Growth Commission – is the ability to break away from the UK's economic patterns of booms, busts, consumer debt and rising inequality.

In a rapidly booming economy, central banks often raise interest rates in order to suppress investment (by making borrowing more expensive) whereas in a stagnant economy they may lower interest rates (to encourage borrowing for investment or spending). A Sterlingised Scotland would be bound to the interest rate decisions of the Bank of England thus when the UK economy boomed and the Bank of England raised rates to suppress growth, the raised interest rates would suppress growth in Scotland too – regardless of the current state of the Scottish economic cycle[19] - while the dropping of rates in the UK to stimulate growth would have a similar impact on Scotland.

This would mean that policy-makers and investors would inevitably based their decisions not just on the needs of the Scottish economy but on the state of the UK economy which would dominate the monetary policy. Sterlingisation would therefore act to harmonise rather than diverge the economic cycles of Scotland and the rest of the UK and would make intentionally trying to diverge the cycles for the purposes of meeting the tests and attempting to create a Scottish currency much more difficult. Again, this test acts as a significant barrier to a Scottish currency rather than an objective to be met and could result in permanent Sterlingisation.

Why a Sovereign Currency is a More Sustainable Option

Common Weal's proposal is to create an independent Scottish currency beginning very soon after an independence referendum and to build the infrastructure to sustain that currency – including a full central bank – during the period between the referendum and formal independence (we envisage that this process would take around three years to complete). During this period the Scottish currency would be pegged 1:1 to the Sterling largely for technical reasons to do with maintaining a stable exchange rate whilst the banking infrastructure (from bank accounts to IT systems) is installed.

At the point of independence it would be for the Scottish Government of the day to decide how to continue to manage the currency and it may be that the peg to Sterling would be maintained for the purposes of price stability, familiarity and confidence or because that rate is still deemed to be the "best" for Scotland and its economy.

Whilst the peg is in place, Scotland would have limits on its monetary policy – interest rates could not diverge much from the rest of the UK's rates without instituting capital controls to limit the flow of money across the border [20,21] - these limits would be entirely self-imposed rather than imposed on Scotland by a central bank on which it is not represented or by private financiers to whom Scotland is

18 BBC, "HS2 'Losers' Revealed as Report Shows Potential Impact", 19th October, (2013)

19 The term "economic cycle" is somewhat objectionable as it implies an inevitability to economic booms and busts when other economic models such as those based on low or zero growth economies and a focus on managing inequality and environmental degradation may be more sustainable. The term is retained here purely by convention and context.

20 There exists in economics an "Impossible Trinity" whereby a country can select only two out of three of a choice between full monetary policy, stable exchange rates and zero capital controls.

21 M Obstfeld, J C Shambaugh and A M Taylor, "The Trilemma in History: Tradeoffs among Exchange Rates, Monetary Policies, and Capital Mobility", The Political Economy of Globalization, March, (2004)

beholden for liquidity. Scotland could, if it chose, break this peg at any time and either try to establish a new currency peg (perhaps to the euro, or to a basket of currencies) or simply allow the currency to float on the market. This process could be done very quickly as evidenced by the experience of the Swiss Franc on the 15th of January 2015 when the Swiss central bank unexpectedly and without warning announced that it was delinking the currency from the euro. Within minutes, the Swiss franc had appreciated in value by about 20% though in the three years since it has slowly depreciated back to near its previous value.

By contrast, if a Sterlingised Scotland found itself in a position where the Sterling was no longer adequate for Scotland's needs it could not move nearly so quickly. If the "six tests" were in place, then they would have to be met – including the ones which the process of Sterlingisation itself actively works against. Then, if the tests are somehow met and Parliament agree to set up a new Scottish currency, the process detailed by Common Weal would have to be followed. It is not possible to significantly shorten the three year time period identified (much of which involves designing IT systems to be compatible with the new currency and ensuring that all Scottish residents who wish to trade in the currency have access to a bank account and financial services) so it would inevitably be the work of nearly an entire Parliament to launch a new currency after the point at which the decision to create one is made.

A Scotland with its own currency will have a much healthier relationship with its economy than a Sterlingised Scotland, the latter of which will inevitably be forced into permanent Austerity by a combination of self-imposed financial restrictions and restrictions imposed by those from whom Scotland would rely on for a supply of money.

The Scottish Government has already objected to the term "Austerity" being applied to the fiscal restraint measures in the Growth Commission report but there is no other word which applies so closely to them. By self-imposing a restriction whereby Scotland could only increase public spending by a percentage not exceeding GDP growth then Austerity is the consequence. One can imagine a scenario whereby GDP grew but wages did not, in which case suppressed public spending would increase the costs of living for the Scottish public. One could also imagine a scenario where tax revenues increased but GDP did not (say, by the closing of tax avoidance loopholes) in which case the additional revenue could not be spent into the economy and would instead be removed from it and cause GDP to shrink.

The case can be made that short-term price (or, more accurately, pricing) stability is important to many people and that this demands that some measures be taken in the early days of an independent Scotland to ensure that some sense of continuity is felt on currency but to do this by Sterlingising rather than by creating a new currency and pegging it to Sterling opens Scotland to significant structural and systemic risks as well as continuing to chaining itself to the systemic risks of the UK economy. The fact that the tests set up to move to a new currency after Sterlingisation seem to be actively opposed by the act of Sterlingisation itself mean that this policy cannot be fairly described either as transitional or as temporary. The monetary policy proposals in the Growth Commission's report do not lay out a framework which leads to an independent Scotland with its own sovereign currency, will actively hinder the prospects of creating one and will hobble the Scottish economy for decades after independence. Proponents of an Austerity-free Scotland and proponents of Scotland having its own currency at any time after independence should reject these proposals.

www.allofusfirst.org

craig@common.scot

3rd Floor, 111 Union St,
Glasgow, G1 3TA

COMMON WEAL POLICY