Scotland’s National Bank
Central Banking in an Independent Scotland—
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Preface

One of the likely early priorities for an independent Scotland will be the founding of a new central bank. These institutions play an important role in government policy and regulation. How they are set up and what relationship they have with other functions of government plays is also crucial in determining the national outlook on macroeconomic policy.

However, as this paper demonstrates, the history of central banking is long and constantly evolving depending on the circumstances in which countries find themselves at any given time. Even today there are many models of what a central bank may look like and there is certainly no one “correct” answer to be applied.

This paper examines the history of central banking, the roles and responsibilities of central banks, how they fund themselves and culminates in a proposal for a central bank for an independent Scotland.

Key Points

• The history of central banking covers nearly 350 years with the oldest institutions, like the Bank of England, being formed initially as purely commercial ventures.

• As economies and political institutions have grown, shrank, expanded, globalised and suffered shocks, the roles of central banks gradually became immersed into the policy-making functions of governments.

• Broadly speaking, the roles and responsibilities of central banks cover areas such as currency issue, financial monitoring and regulation, price stability, trade stability, and financial clearing between commercial banks.

• However, each central bank places its own weight on each of these priorities and some countries split roles – especially regulatory roles – between other specialised offices.

• Central bank independence – the idea that central banks should not be influenced or controlled by governments – gained traction in the early-to-mid 20th century and largely remains the current policy today. The temptation for politicians to subvert the central bank and align macroeconomic policy to political advantage is powerful.

• However, sentiment has varied at times and many have queried whether a bank operating completely independently of government makes for efficient policy or can be compatible with democratic governance and accountability.

• Post the 2008 Financial Crisis and the increasing interventionism by central banks through programs such as QE, the discussion about central bank independence has been re-opened.

• One suggestion to increase democratic accountability within an “independent” central bank could be to adopt a “stakeholder” model of board governance whereby the board is made up not just of bankers but of representatives from other public spheres such as trade unions, agricultural and industrial representatives and other similar bodies.

• The cost to administer a central bank scales strongly with the size of the host country. A central bank in a country the size of Scotland could expect running costs of around £140-£200 million per year. However, central banks are usually profit-making enterprises once operational.

• A Scottish central bank could expect to employ between 350 and 1,000 people depending on roles and responsibilities.
Introduction

One of the early priorities for a newly independent Scotland will likely be the founding and running of a central bank. This will be particularly important if Scotland desires to launch its own currency and, thus, maintain an independent macroeconomic policy.

Whilst the task of setting up such a lynch-pin institution may seem a daunting challenge to some, it is a process which many countries have undergone – sometimes whilst experiencing circumstances far less secure than Scotland’s would be.

The purpose of this paper is to summarise the history of central banking and to explain the roles and responsibilities of a central bank. It shall then explain the costs involved in running such an organisation before outlining a potential structure of a Scottish Central Bank including how it would interact with the rest of the Scottish Government and with the Scottish Constitution.

An Extremely Brief History of Central Banking

The history of central banking is long and gradual and as such it can be difficult to define how and when the concept, as it is known today, came to be. Certainly, some of the institutions now identified as central banks were not founded as such. The oldest of these – such as the Swedish Riksbank (founded in 1668) and the Bank of England (1694) – were formed initially as joint stock banks thus were private organisations owned by their shareholders, not by the government. These and other similar banks did involve themselves with the government by providing loans but they also often accepted deposits from individuals and companies and acted as a clearing house between transactions in much the same way that modern commercial banks operate.

Some of these banks were, however, granted monopolistic rights over certain aspects of monetary policy such as the right to print banknotes (which were themselves becoming established as a medium of exchange around this time). Similarly, the Bank of Scotland was also founded in 1695 as a joint stock company and quickly developed a near-monopoly over the issuance of coinage and paper currency. This monopolist strategy was found to help stem the inflation caused by the over-issuance of currency by the many commercial banks of the era as economies adapted to the concept of money becoming backed by metals or assets rather than being directly issued as precious metal coins.

The 18th century saw a period of increasing economic complexity along with punctuations of booms and busts. The disruptions of the Napoleonic wars to the speculative crash of the South Sea Bubble, amongst others, often sent people to their banks to convert their paper money back into the gold or silver it purportedly represented. This often led to banks dangerously depleting their reserves and thus approaching the nascent central banks – with whom they often already had extensive dealings – for support. By the end of the century this had developed into the concept of the “lender of last resort” - the organisation which could be depended on beyond all others to provide liquidity when necessary.

At this stage an organisation which could be properly called a central bank had been formed, being defined by its roles as a) the bank with which the government deposited and borrowed from, b) the monopoly note issuer for the state and c) the lender of last resort.

The most substantial development in monetary policy in Europe and the United States through the 19th century was the consolidation under and transition to the gold standard from silver and bimetallic standards which had until then been dominant. The United Kingdom moved the Pound Sterling – originally defined as the value of 1 troy lb of sterling silver (approximately £150 at 2017 prices) – in 1812 with other countries following in the decades following. The Napoleonic wars in particular had a great influence in this process as many economies (particularly those of France and the United Kingdom) had financed the wars by cancelling the convertibility of their paper money back into gold/silver and then printed as required. This, as could be expected, often caused inflation within the economy and/or the devaluation of the paper scripts especially after the war. Shortages in silver supply along with new gold discoveries and innovations in processing changed the relative value between the two metals which disrupted the bimetallic systems.

Central banking in this period was largely focused on maintaining convertibility between currency and gold and was less interested in modern concerns like interest rates (indeed, as many countries defined their currency by weights of gold exchanging between currencies was less of an issue than it is now). Economic policy was largely focused on either obtaining supplies of gold/silver via the world’s mines or by ensuring a sufficient trade surplus with which to purchase these metals from those who had it in excess. This state of affairs would exist, slowly evolving, until 1914 and the outbreak of World War I. During this conflict the convertibility of many currencies to gold was suspended which allowed the governments to issue bonds and print money to pay for the war efforts. One recently uncovered event during this period was the issue by the UK of a war bond which was held up by the press at the time as an oversubscribed success. In fact, the bond raised only about a third of the capital intended and the UK government worked with the Bank of England to use the bank’s own reserves to buy the excess bonds – an early form of what is now known as Quantitative Easing – and then to disguise the transaction in their accounts.

The great economic disturbances caused by the war and, later, by the 1917 Bolshevik Revolution prompted European governments to re-assess the previous laissez-faire regime.

The wave of social reforms throughout Europe and America and increasing demands from the populace prompted central banks to begin to turn their attention towards not just monetary stability but to the stability of their host nations’ domestic economies as well. Further, the Great Depression of the 1920s and 1930s put an end to the gold standard in many European countries resulting in the spread and tightening of capital controls as a means of arresting exchange rate fluctuations. The resulting trend towards protectionism and domestic output (which avoided increasingly punitive tariffs) led to even more focus on the importance of domestic economies.
World War II again brought turmoil and change to Europe with the war all but bankrupting the entire continent and leaving its industrial and manufacturing base in ruins even where the maps and borders of entire countries weren’t redrawn. Even before the end of the war, the Allied countries began talks about reconstruction in the eventual peace. The Bretton Woods monetary system, international financial organisations such as the World Bank and the IMF and the idea of the economic, financial and political integration of Europe in a manner designed to ensure peace and mutual dependence were all born out of these talks. Key figures such as John Maynard Keynes drew on their pre-war work and laid down plans which would pave the way for several decades of growth and prosperity where the labour unions and political institutions became far more important and influential in national political and economic development than the financial institutions were. Banks, at this time, were largely subsumed into not much more than a department of government.

However, warnings were sounded even at an early stage that this political paradigm held within it the potential of its own demise as full employment and rising wages could eventually cause the stagnation and collapse of the economy. In the UK, this appeared to occur from around the mid 1970’s and led to the Thatcherite revolution which, in many ways, built precisely the opposite system to the Keynesians in which finance took the reins of power from the labour market and government itself.

Throughout the 1980s and 1990s, the rise of the power of the banks and financial institutions occurred via a consistent pattern of the deregulation of banking and the development of more complicated financial instruments and derivatives as well as by the entrenchment of laissez-faire ideas into the political system such as the demand for central bank independence becoming a key article in what is now the European Union’s membership criteria – the Bank of England would become an entity independent from government again in 1997. It was also dramatically demonstrated in the UK in 1992 with “Black Wednesday” when the UK Government was challenged to defend its peg of the pound sterling to the European Exchange Rate Mechanism. Despite the UK Government spending £27 billion of its reserves (about £50–£53 billion at 2017 prices) it failed to maintain the peg and the UK was forced to drop out of the ERM.

As the post-war Keynesian paradigm lasted around 30 years before collapsing to the vulnerabilities of its own system, so the neoliberal Thatcherite system also survived around 30 years until the unfettered actions of global financial institutions brought the developed economies to their knees with the 2008 financial crisis. Central banks around the world, including the US Federal Reserve, the European Central Bank and the Bank of England, created trillions of dollars worth of money and pumped it into the system in order to stave off collapse. A decade on from those initial events, many developed economies are still fragile and the role of central banks in maintaining stability continues to evolve with many asking if it is time to return to the Keynesian ideas of stronger control by governments and democratic institutions. Meanwhile, the rise of innovations such as cryptocurrencies may lead to solutions to financial problems which do not involve central banks at all or, at least, will have to be adapted into the systems used by central banks. The lesson from nearly 325 years of the history of central banks is that they have often looked very different to that which they were a generation previous and that their place in national and global economies is one subject to constant evolution.

The Roles and Responsibilities of a Modern Central Bank

Since (in most cases) withdrawing from the realms of commercial banking, central banks have been placed in a position above that of the commercial banks and thus are no longer in direct competition with them and nor do they have much incentive remaining to use their position to affect and effect national macroeconomic policy to their own advantage. The roles and responsibilities of a modern central bank have become much more strictly defined.

Currency Issue

As previously stated, one of the oldest responsibilities of a central bank is the issuing and backing of currency. In previous times this would have also involved setting the face value of coins compared to the value of the precious metal of which they comprised. The bank would have collected silver and gold as deposits but a coin with a face value of, hypothetically, £1 would normally have contained less than £1 worth of silver or gold. The difference would have been retained by the bank and represented an income known as seigniorage. Changes in this ratio by using less precious metal and more “base” metal (such as copper) was known as “debasement” and was used to increase the money supply or spending power of the government (and often resulted in price inflation afterwards).

In modern times of fiat currency, seigniorage still exists as it still costs far less to produce a coin or note than their face value for all but the smallest denominations. If a retail bank wishes to issue currency, such as a banknote, that it doesn’t currently possess, it must make an electronic deposit with the central bank to that face amount. The central bank is then able to deposit the money in an interest bearing account and earn an income until the issuing bank returns the banknote and requests the return of the capital (this fulfils the “promise to pay the bearer on demand” seen on many UK banknotes). In practice, the coins and notes are often only returned when they become too worn to use and are simply exchanged for a newly minted/printed currency. Scotland continues a practice now unusual amongst countries in that it maintains multiple note issuing banks (where notes issued by the Bank of Scotland, Royal Bank of Scotland and the Clydesdale Bank are accepted alongside Bank of England notes. Coins remain the sole issue of the Bank of England). These notes are still fully backed by deposits in the Bank of England and if an independent Scotland chose to continue the practice of allowing these “commercial banknote” issues under its own currency regime it would be logical to assume a similar system could be put in place.

Financial Clearing

The modern economy is complex and inter-connected. Multiple retail banks exist and trade with millions of customers every day. Businesses also buy, sell and take payments for goods and
services. However, we all expect that if we attempt to purchase something from a business then our payment will be accepted regardless of which bank our account is held by and which bank the business deals with. We also expect to be able to draw money in our account from an ATM whether or not it is owned by the same bank as who holds our account.

It would be immensely cumbersome and, likely, very expensive if every single trade was processed between banks at the point of agreement so central banks often provide what is known as a clearing function by which the banks record their various trades through the day and then settle them at an agreed time with the central bank making itself available as an intermediary to ensure the efficient settling of all of the accounts.

In practice, central banks are not the sole provider of clearing functions - commercial banks and specialist clearing houses also provide such services - but the central bank remains a key component of the process with access to several advantages over commercial banks in some respects such as unlimited access to liquidity (as the central bank defines money supply), the ability to define the cost of transactions (by being the controller of the base interest rate) and its inherent competitive neutrality (by being apart from the commercial banking sector).

Financial Regulation

This responsibility of central banking is possibly the sector in which even an “independent” bank acts at its most political and in closest relationship with the government. The modern world is one in which the financial industry is both incomprehensibly complex but also now make up a substantial proportion of modern developed economies. A briefing paper for the House of Commons shows that the financial sector comprised around 7% of the total Gross Value Added to the UK economy in 2016. For comparison, the oil & gas sector comprised around 6.7% of the Scottish economy in 2016, down from around 15% in 2009. With a sector this size, there is substantial risk that a failure within the sector would have adverse effects on the overall economy of the country so it is important that not only is the sector monitored for risk factors but it is also actively regulated.

How this regulation takes place, by whom and how they go about it is a very individual decision for each country but in many the central bank plays a key role within the regulatory framework.

A 2000 study by the Centre for Central Banking Studies compared and contrasted the functions and powers of 37 central banks and found a substantial level of variation in their scope and powers (it should be noted that as this study is now quite dated and in particular was published before the global financial crisis of 2008 and the reforms which came in its wake). The UK, in particular, was noted as preferring to have its central bank operate alongside multiple regulatory agencies specialised for different sectors.

Core to most central banks, however, is the concept of Lender-of-Last-Resort described earlier in which the central bank is the body to which other financial organisations go when in need of emergency support or liquidity. For a country with its own currency, this liquidity is almost always available for so long as the government and central bank is willing to support the ailing organisation until any reforms are made and for as long as it is acceptable to deal with the consequences of the support actions (such as any inflationary effects of increasing the money supply through bail-outs).

With respect to the 2008 crisis, there is a growing body of evidence which links the crisis to the trend of “deregulation” in developed countries which in turn allowed the financial industry to increase their debts and liabilities to the point that when the crash came the systemic risk to the wider economy became critical. Whilst countries such as Iceland are sometimes praised for their fairly decisive action after the recession with regard to punishing people who created vulnerabilities within the sector, less prominent are countries such as Jamaica who – after learning lessons from a previous housing crash in the 1990s – weathered the 2008 storm in their financial sector far better than many other similar countries (although the subsequent negative impact to their economy caused by a contraction in the global tourism industry has since caused financial difficulties of a different kind).

The lesson therefore is that a country seeking to form its policy regarding financial regulation should not just weigh the costs of a well developed regulatory framework but should also carefully weigh the potential costs of not doing so and thus suffering a greater weight of the next economic crisis when (rather than if) it comes.

Balance of Payments

National economies do not exist in a vacuum and their trade with the rest of the world can result in important considerations for macroeconomic policy. Countries with large, sustained trade surpluses tend to accumulate foreign currency and capital whereas countries with large, sustained trade deficits tend to see their reserves deplete which can result in a liquidity crisis as the country runs out of the ability to pay for the goods and services it needs. This was particularly important during the era of the metal standards where the major economies (especially those without access to a ready supply of mined gold or silver either in their home territories or in their colonies). In these cases, it often fell to the central bank to regulate the supply of credit which would either inflate or deflate prices and wages across the economy in a way which was intended to adjust the balance of trade towards a more favourable balance. Since this era, the idea that prices and wages should be manipulated (particularly the latter, particularly downwards) to maintain the balance of trade has fallen out of favour and the opening up of exchange rates between currencies has led to appreciation and depreciation in currency value to become a more prominent lever with which to manipulate the balance of trade. A country with a sustained trade deficit will tend to see the strength of their currency depreciate but as this happens the price of imports becomes less competitive and the price of exports rises, which should reduce the deficit. This said, the increase in globalisation and supra-nationally connected supply chains has led to the situation where an exported good (such as a car) which relies on imported components (such as engines or electronics) may become relatively currency invariant as the decrease in price of the final exported product may be counteracted by the increase in price for the components. This has been recently highlighted by the fact that the depreciation of the pound sterling in the wake of the
2016 EU referendum has, as of the time of writing, had limited effect in stimulating the UK’s domestic manufacturing.33

Price Stability

Price stability is now considered one of the foremost objectives of many modern central banks.34 Inflation – the annual change in price of a defined “basket” of goods and/or services – is monitored closely by the bank as it can have negative effects on the economy if it reaches extreme levels. If inflation is positive – if the “basket” becomes more expensive or if a defined cash value buys fewer goods/services – then the value of a fixed income reduces and people can find their cost of living increasing. The value of savings is also eroded (especially if inflation exceeds the rate of return of the investments or interest on the savings) although the value of a debt is similarly eroded. It can therefore be seen that how one is affected by inflation depends on whether one has wealth or debts and whether one’s income is able to maintain its value (via wage increases or similar) with respect to inflation.

However, in a deflationary period, the economy can be negatively affected as well. If prices are declining for an extended period of time then consumers may defer spending in the present in order to buy the same goods cheaper at a later date. If enough people do this, it can cause stagnation in the consumer economy and result in a rise in unemployment.

Many central banks therefore define price stability as an extended period where the annual inflation rate is close to 2%, which is supposed to have the effect of allowing those with savings to maintain the value of them whilst allowing prices to rise just fast enough to stimulate spending in the economy.

The primary tool that central banks maintain in order to manipulate the rate of inflation is their monopoly control of the state’s base interest rate (this is the rate at which the central bank lends funds to other commercial banks thus the lower bound of the rate at which they must lend funds to other people and companies). By increasing the interest rate, loans become more expensive and savings become more profitable so spending becomes discouraged which reduces demand in the economy thus should reduce prices. The opposite case is also intended where a reduction in base interest rate encourages lending and spending which is intended to increase demand in the economy.

Despite the rate cuts, the economy remained fragile and it is difficult to reduce rates below zero. Negative rates are not unprecedented but come with their own consequences. If the commercial banks passed on the negative rates to savers, this would mean a percentage based fee on savings which would likely have a substantially larger psychological impact than merely reducing savings interest rates would.35 Other tools were therefore required to help maintain the economy.

The outright printing of money is generally discouraged by conventional bank policy as whilst it can increase the money supply in the short term, if no measures are taken to reduce supply afterwards then inflation and/or a drop in currency strength can occur which reduces the real value of the total money supply back to the pre-printing levels (and leaves anyone who couldn’t acquire any of the extra money poorer for it).

The conventional alternative, as has been in practice since the 2008 financial crisis, is the idea of Quantitative Easing or QE. This method involves the central bank creating money (in this case digitally rather than by printing currency) and using it to buy government bonds from the open market. This reduces the supply of the bonds available for sale which pushes up their price and in turn reduces the effective yield for anyone else who purchases one (for example, a £1,000 bond earning 2% interest would pay out £20 per year. If it is bought for £1,200 it would still pay out a flat £20 per year so the effective rate of return for the investor is now only 1.67%).

The hope was that by reducing the yield on the government bonds, the investors who sold their bonds would not re-buy more government bonds but would instead switch to other instruments like company shares. This, again, would push up prices in and lowers yields from those shares and so the effect would be a reduction in the interest rates across the economy without having to reduce the base rate below zero.

A secondary effect of QE is a reduction in the amount of interest paid by the government to service its debt. Whilst it still has to pay interest on the government bonds owned by the central bank, in most countries – including the UK – the central bank is owned by the government and so the profits earned by the bank are returned to the Treasury. As of 2017, the Bank of England owns approximately 25% of the total amount of government’s debt36 so approximately 25% (£13.2 billion in 2016-17)37 of the gross debt interest paid by the government is returned to the Treasury.

One of the problems of the idea of QE as it has been used in the UK is that whilst the ultimate goal was to increase consumer spending, almost none of the money created filtered down to the consumer level. Both banks and companies were still reeling after the 2008 crisis and were seeking to increase their capital reserves to weather a future crash so the money they received from the bond purchases often remained in their vaults. Additionally, whilst interest rates have reduced over the course of the QE program38 potential consumers have found their basic costs of living increase faster than their wages and have found that even despite the reduced interest rates levels of private debt are reaching unsustainable levels. As of 2017, the typical UK household carries debts of around 140% of disposable income.39 With inflation increasing above 2% in mid-2017, the Bank of England now faces the dilemma that it may not be able

The 2008 financial crisis saw UK rates rapidly reduced from the more-or-less historically average rates of between 4 and 6% down to historically unprecedented rates of 0.5% - and was reduced further to 0.25% in August 2016.
to slacken QE or raise interest rates without causing defaults and bankruptcies in the private debt sector. Unless a solution is found this may prove to be the seed of a forthcoming financial crash.

Central Bank Independence

The History and Present of Central Bank Independence

In a modern sense, the idea of central bank independence is characterised by the governments allowing their central bank to monitor the economy and to set interest rates, inflation targets, liquidity levels and manipulate other such macroeconomic levers without guidance or instruction from government. In practice many banks, such as the Bank of England, still maintain some link to government in the form of the appointment of the Governor and other senior positions.40

The relationship between central banks and their state governments has been one of oscillation between the banks being largely independent, even privately commercial, concerns to them being tightly controlled to the point of being subsumed as just another department of government.

In the late 1920s, for instance, the then Governor of the Bank of England, Montagu Norman, stated that while he valued his “unique right” to lend advice to the government he was “always of course subject to the supreme authority of the government”.41

By the 1950’s, the pendulum had swung firmly to the opposite extreme with the West German Chancellor attacking the Bundesbank’s independence saying in 1956: “Here we have a body that is not accountable to anyone, neither to parliament nor to the government.” Although it should be noted that public reaction to the speech was such that it was later withdrawn and the bank’s independence protected.42

Since the economic fluctuations of the 1970’s and 1980’s there was an increasing trend towards granting central banks more independence, largely on the basis that by allowing banks to make their own decisions and by allowing them to be run by experts in the financial sector, they would generally make better decisions. Additionally, the periods of hyperinflation in Europe (particularly in Germany) developed a feeling that allowing politicians unfettered access to certain macroeconomic levers – particularly levers such as the option to print money – would inevitably mean that those levers would be pulled and pulled hard.

Within the European Union it has been a legal requirement since 199243 that both the European Central Bank and the Central Banks of the EU member nations should all be independent of both the EU and of the governments of the member states and this remains true, at least on paper, to this day. The UK’s Bank of England was only made formally independent of government as recently as 199844 in a move initially designed to pave the way towards the UK’s entry into the Eurozone.

However what precisely is meant by Central Bank Independence is itself subject to some debate. A 2000 study45 by the Bank of England which asked 60 Central Banks from developed and developing or transitional nations to self-describe their own definition found eight common responses.

A) Independence in policy implementation:–
The most important factor, by far, in deciding if one’s central bank was “independent” appears to be the freedom to implement policies once they are determined without interference or oversight from the government although it is acknowledged that in practice this principle may be significantly undermined or affected by other factors mentioned such as the ability of the government to appoint senior board members.

B) Ability to form policy:–
Second in importance to implementing policy is an independent central bank’s ability to form said policy. However, many “independent” central banks mentioned that they recognised the mutual relationship between the bank and government in this respect and that in many instances policy is formed by close discussion and mutual agreement.

C) Existence of statutory objectives or legal mandate:–
Closely related to the above two categories, 38% of respondents stated that they felt independent when they could work to legally defined objectives thus were not subject to whims of the government of the day with regard to policy direction.

D) Ability to set targets, objectives or goals:–
The ability to set independent targets and objectives was valued by only 22% of central banks in the study but those who did appear to have felt quite strongly about the subject with one respondent posing a counter question regarding the use of instrument independence if the government sets binding politically motivated goals? Clearly in such a case the bank would find its policies and procedures bound so as to meet those goals.

E) Independence from political bodies in general:–
As stated earlier, many central banks – including the Bank of England – either have their senior members appointed by or recruited in consultation with the government so it is perhaps no surprise that only 20% of surveyed banks felt that this impinged on their independence.

F) Specific rules on senior officials’ terms of office:–
In a now famous speech to the House of Commons,46 Tony Benn MP laid out five questions defining democratic accountability the last of which was “How do we get rid of you?”. By having specific rules on how central bank positions are both filled
and are rendered vacant (by the ordinary tenure cycle and via removal from office in extraordinary circumstances) a central bank can feel more independent and less subject to a government who may, for example, be tempted to remove an objectionable governor from office or to retain a pliant one beyond a set time or against the wishes of the board. However, only 18% of banks felt that this was a particularly important issue.

G) No deficit finance:-
One of the often highlighted advantages of central bank independence is the ability for the bank to refuse to print money to cover a government’s deficit spending. Indeed Chapter 17 of the EU’s criteria for membership of the Union – as laid out in the Maastricht Treaty – specifically states that central banks cannot be used to fund public services. It is somewhat surprising therefore that only 10% of banks surveyed felt that providing such finance would impinge on their independence (although the survey question does not indicate how the banks felt about the soundness or lack thereof of such a policy).

H) Communication without constraint:-
Only 8% (five banks) felt that the ability to communicate without restraint was important to their concept of independence. The reasons for this low response are not expounded within the study though in a 2011 speech the then Governor of the Reserve Bank of India Duvvuri Subbarao spoke of the weight of responsibility upon central bank figureheads when communicating with governments, the financial markets and the general public and noted a growing pressure to speak not just about policy recently enacted but transparent disclosure of future proposals too.

Also noted was a temptation of central bankers to resort to “Delphic utterances” so as to avoid any clear statements which may later be held against them.

In an era of 24-hour news and media spin, this can occasionally lead to political capital being made out of polarising otherwise neutral statements. Followers of the Scottish independence debate may recall the great deal of attention paid towards Bank of England Governor Mark Carney during and immediately after the 2014 independence referendum in which a number of press headlines were generated on both sides of the debate based on statements regarding the future of currency in Scotland and the UK.

The Future of Central Bank Independence

As stated earlier, the idea that a central bank must be independent from its host government is a principle which has come and went several times over the history of central banking. Whilst the concept is firmly embedded in structures such as the Maastricht Treaty (which, unless changed, Scotland would need to adhere to if it wished to be a member of the European Union) the material change in circumstances since the financial crisis a decade ago has resulted in programs such as QE which have either tested this principle or have been created to outright skirt it. There also remains the fundamental question of whether the presence of an “independent” agency acting within and with so much power throughout a governmental system is compatible with the values of a democratic society. On the other hand, for all the lack of trust the public generally has for appointed technocrats and “experts”, there remains a similar lack of trust in the ability and motives of even elected politicians and the fear that they could manipulate macroeconomic policy for political gain (by, for instance, printing money or reducing interest rates shortly before an election) is a real and important one.

The idea that central banks may be actively designed to prevent future shocks is being debated and contested and show that the future of central banking is far from determined. Ideas such as “narrow banking”[50, 51] seeks to limit or quarantine activity within the speculative financial sector to reduce the scope of any future financial crisis and to prevent its effects from adversely impacting the wider economy. Other regulatory principles such as “full-reserve”[52, 53] banking would restrict or prohibit commercial banks from increasing the money supply and therefore seek to return monopoly control of the money supply to the central bank in the hope that this will allow easier control over inflation and credit supply. It should be said, however, that both of these ideas in particular are themselves[54, 55] subject to contention and debate.

The future of central bank independence will, ultimately, be as much a political decision as it is an economic one and as such will have to be adaptable to the circumstances of the economy and respectful of the needs and desires of the populace and their elected government.

Ownership and Governance Models

As with the roles and responsibilities of a central bank, the ownership of the bank and the structure of the governing board is subject to a substantial degree of variance across countries. In some countries, like the USA, the bank is entirely privately owned. In others, ownership is mixed (Greece, for example, forbids the state from owning more than 35% of the central bank’s shares)[56] whereas in others still (such as the UK), the bank is wholly owned by the State.

The board directors and the bank governor may be appointed by the governments, by the directors themselves or – in the case of monarchies – by the Crown. In the UK, with its largely symbolic constitutional monarchy, the Directors select and recommend their preferred Governor to the Prime Minister who in turn recommends the candidate to the Crown who makes the formal appointment. In theory either the PM or the Monarch could select their own candidate over the recommendation of the board but this would carry significant political consequences and, in practice, would likely be considered an extraordinary event.

As the bank carries a great deal of responsibility and because “…people in power normally appoint others to centres of power with whom they are comfortable…”[57] it is often the case that appointees are drawn from within fairly tight circles within banking and economic academia. This can be compounded by the often highly technical nature of the role which can demand previous expertise in the field as a prerequisite for selection.

Portugal, for instance, recognises that such closed circles can easily become victims of closed thinking or can lack in representation from other sectors of the economy. Some countries therefore institute requirements for a broader
“stakeholder” style board whereby representatives from trade unions, agricultural bodies and other economic sectors must be represented. Banks may employ multiple boards for this purpose such as a policy and/or implementation board which draws on specialised expertise alongside a broader advisory board which can contribute towards policy without requiring the narrow technical knowledge necessary for implementation. Finally the relationship between the governor and the board can be considered. Some banks will treat the board as merely an advisory body with the governor’s eventual decision being final whereas in others, decisions are placed to a vote or the governor may be over-ruled (although this may trigger a loss of confidence in and the resignation of the governor).

Ultimately, the model and structure of a central bank is clearly flexible to the needs of its host country and that no single “correct” model can be identified.

Central Bank Funding

Given the large variation in the scope of powers granted to central banks it should come as no surprise that the running costs of central banks around the world also show substantial differentiation.

It can also be logically deduced that monitoring and regulating a larger economy will incur greater expense than doing so for a smaller economy therefore it could be expected that the operating expenses of a central bank will scale according to the GDP of the banks’ host nation. A study of 42 developed nations tracked by the OECD and EU combining their GDP data with the accounts provided by each of the nations’ central banks shows that this scaling does indeed exist.

By this measure it can be seen that whilst an economy of scale does exist it is fairly small with only a cost factor of between two and three being found between the smallest and the largest nations.

Far more important than the size of the nation appears to be the scale and scope of the central bank itself. Some countries either perform less regulation and monitoring than others or, at the very least, outsource such monitoring to other bodies whereas other nations are much more active. One notable example is Norway with annual operating costs of 0.18% of GDP as their central bank is directly responsible for administering the global investment portfolio of their Government Pension Fund (which was generated by surplus oil revenues).

It should also be noted that several of the extreme outliers to the above trend are nations such as Russia (0.35% GDP), Greece (0.25% GDP) and Brazil (0.18% GDP). These nations have seen their economies contract sharply in recent years which has inflated their respective cost/GDP ratios.

One may hypothesise that countries entering the Eurozone could see significant reductions on their central bank as many of the functions of their national central banks would be taken over by the European Central Bank. Whilst the data shows that there may indeed be some saving, they appear to be slight compared to the other factors which determine central bank expenditure.

One potential argument against Scottish independence in particular could be the idea that setting up a Scottish central bank would result in additional expense over and above that which is already being paid for as part of the Bank of England’s remit over Scotland. The argument goes that a kind of “economy of scale” exists whereby certain fixed overheads are spread across larger countries so that even though their overall operating expenses are greater, their expenses as a proportion of national GDP is lower. This too can be tested by recalculating the above operating expenses as a proportion of national GDP.

Of course central banks are not simply consumers of public money. They are investors and revenue generators in their own rights. The seigniorage on currency issue - interest earned on debt and liability holdings and income generated by other banking activities and services - all result in a considerable income for the central bank. Most are expected to be self-sustaining operations and to run at a profit. Further, most central banks – at least the ones still considered to be nationally owned even where they are operationally independent – deliver all or a portion of their post-tax profits to their national Treasuries thus they provide a direct source of revenue for their national government as well. For instance, the Bank of England’s total expenditure in 2016 was £393 million but overall pre-tax profits were £233 million and post-tax profits were £209 million. An additional £105 million was subsequently paid to the UK Treasury under the terms of the Bank of England Act.
Scotland’s National Bank

Given the body of evidence above, a potential outline of a Scottish Central Bank can be created. The actual creation of a new central bank has been described as “not a big problem” with the major task simply being the recruitment of senior staff with the required skills and international reputation as well as sharing the vision of a successful, independent Scotland. In terms of skillset and governance development both the IMF and the EU have an established track record of aiding the development of the financial and macroeconomic sectors of the post-Soviet countries of Europe. Additionally the Bank of England has long produced a detailed series of handbooks and training packages designed to assist emerging market economies in the post-Soviet as well as African and South American regions. The motivation for this assistance comes about via the mandate these organisations hold to ensure and encourage stable economic conditions and thus exists above and beyond the political concerns which often dominate disputes and debates in the run up to major decisions such as an independence referendum.

In terms of the structure of the central bank, a “stakeholder” style board of directors which draws from multiple sectors of the economy, rather than merely from the financial sector, should be seriously considered. Scotland’s economy is diverse therefore those who seek to influence and control the economy should also be drawn from a diverse field. This will also aid the sense of democratic accountability even if it is to be the case that the bank remains operationally independent from government as its board may be appointed such that it better represents the demos of the people of Scotland.

Of course, in no sense could it be reasonably claimed that Scotland is any less capable of transitioning to a functioning independent economy than any of the states which have already successfully undertaken this process and, in any case, Scotland’s transition will certainly be assisted by the fact that it is already a developed market economy within the United Kingdom.

One suggestion sometimes offered from which a Scottish central bank could be built may be one of the commercial banks nationalised in the wake of the financial crisis. At the time of writing, RBS is 73% owned by the UK Government via the UK Financial Investments company. If this is still the case at the point of Scottish independence then it is possible that the ownership of the bank may become a topic of the debt and asset separation negotiations. The structure, roles and responsibilities of a commercial bank are, however, significantly different from the structure, roles and responsibilities of a central bank as are the skills required by many of the personnel. The effort required to restructure and rework a bank acquired for this purpose may well therefore be at least as much as the effort required to design a new, bespoke central bank from first principles. The principle of non-competition which requires that a central bank remain apart from and above the commercial banks would also mean that restructuring a commercial bank into a central bank would have significant implications for customers, both within and outwith Scotland, who hold accounts with said bank. These accounts may need to be transferred to a new bank or an operationally independent division within the restructured bank.

In terms of defining the statutory footing of the Scottish central bank’s roles and responsibilities, this may be done within the constitution of Scotland as has been done by several other countries. For example, Article 53 of the constitution of Croatia states:

The Croatian National Bank shall be the central bank of the Republic of Croatia.

The Croatian National Bank shall be autonomous and independent, and shall report on its work to the Croatian Parliament.

The Croatian National Bank shall be managed and its operations shall be conducted by the Governor of the Croatian National Bank.

The organisation, purpose, tasks and remit of the Croatian National Bank shall be governed by law.

Whilst a constitutional statement such as this firmly places the requirement of a central bank on a statutory footing and grants the organisation its mandate, it still allows a significant degree of scope to discuss, adapt and change the structures of the bank as required by the circumstances the country finds itself in.

In 2014 the Scottish Government prepared a set of documents regarding their plans for the creation of a Scottish Monetary Institute in the event of a Yes vote in the 2014 referendum. This programme was fundamentally premised on the then favoured proposal of Scotland entering a formal currency union with the rest of the UK which would have resulted in most macroeconomic governance over Scotland remaining within the Bank of England. As such, the plans for an SMI were more limited than that which would be required for a full central bank but the roadmap is substantially similar but for scale. In this case, the SMI would have been expected to cost around £77.6 million to initially set up followed by annual running costs (gross of income) of a little under £50 million per year. The SMI was estimated to create between 105 and 445 full time equivalent jobs.

Based on the data presented in the previous section, an estimate of the costs of running a fully fledged central bank may be calculated. As of 2016 Scotland’s GDP is approximately £157 billion. Based on the experience of countries of similar size to Scotland it could be estimated that a Scottish central bank would incur operating costs of approximately 0.09% of GDP or £140 million per year, although a budget of anywhere within a factor of two to three of this figure would be reasonable depending on the level of responsibility granted to it. As Common Weal expects and advocates for a more interventionist and data driven economic policy to be employed by Scotland compared to present circumstances, an illustrative budget of £200 million per
year could be reasonably defended. Scotland’s central bank would therefore be similar in size to that of the banks of Finland, Sweden, Poland or Portugal in absolute terms and similar to Belgium, the Czech Republic or Latvia in terms of percentage of GDP.

For this budget, Scotland could expect to create between 350-550 full time equivalent jobs. Of course, the precise staffing level would be dependent on the eventual activities of the central bank. The SMI plan produced by the Scottish Government posited a central bank option which employed up to 1,000 people – which would be a staffing level on par with examples such as Ireland or the Czech Republic – as this may be required if detailed oversight of an expanded financial sector is developed and maintained within the central bank rather than with an external regulator. It goes without saying that the economic benefit to wherever is chosen to host the central bank by the provision of these highly skilled jobs will be substantial.

Conclusion

The history and development of central banking as well as the wide variation of models used around the world at present has shown that no single central bank size or structure could be considered “correct” for every nation at any time.

With respect to Scotland, a proposal for a central bank designed to monitor, regulate and support an independent Scottish economy has been presented. Whilst the budget for this bank is larger than previous proposals for Scottish monetary institutions it is important to realise the fact that central banks are expected to be profit-making and, thus, self-sustaining (as well as often providing net income to the national Treasury). The benefits which come from a properly regulated and managed economy up to and including active investment in under-appreciated areas will also be important.

An independent Scotland which chooses to adopt its own monetary policy will be required to set itself to the task of creating its own national central bank but it is clear that this task is both eminently possible, economically practical and will pay its own dividends within a very short space of time.
### Appendix – Data Tables

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP (2016 US$mn)</th>
<th>Central Bank Operating Expenses (US$mn)</th>
<th>Central Bank Operating Expenses (%GDP)</th>
</tr>
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<tbody>
<tr>
<td>Australia</td>
<td>$1,169,640.32</td>
<td>$424.32</td>
<td>0.036%</td>
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<td>$438,048.69</td>
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<td>Belgium</td>
<td>$526,364.08</td>
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<td>Canada</td>
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<td>Czech Republic</td>
<td>$366,607.82</td>
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<td>Denmark</td>
<td>$285,363.35</td>
<td>$813.05</td>
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<td>Finland</td>
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<td>France</td>
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<td>Germany</td>
<td>$4,028,364.41</td>
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<td>Hungary</td>
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<td>Ireland</td>
<td>$328,784.65</td>
<td>$268.46</td>
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<td>Italy</td>
<td>$2,312,557.89</td>
<td>$2,348.30</td>
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<td>Japan</td>
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<td>Luxembourg</td>
<td>$61,726.09</td>
<td>$93.45</td>
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<td>$183,290.71</td>
<td>$52.54</td>
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<td>$310,321.42</td>
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<td>Poland</td>
<td>$1,055,354.14</td>
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<td>$316,182.87</td>
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<td>Amount (USD)</td>
<td>Exchange Rate (USD)</td>
<td>Percentage</td>
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<td>----------------</td>
<td>---------------------</td>
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<td>Chile</td>
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<tr>
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<td>$17,180.19</td>
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<td>$3,397,368.41</td>
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<td>Slovenia</td>
<td>$67,901.51</td>
<td>$37.95</td>
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<td>South Africa</td>
<td>$736,936.78</td>
<td>$385.77</td>
<td>0.052%</td>
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<tr>
<td>Eurozone (ECB)</td>
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<td>$1,096.91</td>
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<td>Latvia</td>
<td>$50,847.57</td>
<td>$45.27</td>
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<td>Brazil</td>
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<td>$5,498.24</td>
<td>0.175%</td>
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<td>Saudi Arabia</td>
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<td>$567.27</td>
<td>0.032%</td>
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<td>$871,725.94</td>
<td>$154.37</td>
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<td>Bulgaria</td>
<td>$136,353.40</td>
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<td>0.046%</td>
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<td>$98,618.26</td>
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<td>0.048%</td>
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<td>$27,560.05</td>
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<td>Malta</td>
<td>$16,496.05</td>
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<td>Romania</td>
<td>$462,516.34</td>
<td>$105.94</td>
<td>0.023%</td>
</tr>
</tbody>
</table>
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60 Data gathered from central bank annual accounts covering 2016 as published on their respective websites and converted to US dollars.


