How To Launch a Scottish Currency

—Preparing Scotland for monetary sovereignty from day one of independence—

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**Preface**

This report draws together Common Weal’s body of work studying the case for an independent Scotland to launch its own currency rather than to adopt alternative proposals such as to join a currency union or to unilaterally and unofficially circulate UK Sterling – a process known as Sterlingisation. The process for launching a Scottish currency so that it is operational by day one of political independence is then outlined.

This proposal is contrasted with the proposal laid out by the Sustainable Growth Commission which adheres to a policy of Sterlingisation coupled with a set of policies and “six tests” which would actively prevent Scotland from launching a currency post-independence.

The final part of the report examines the case made that Scotland could not maintain a currency – especially one pegged to the Sterling – as it would be attacked to extinction by currency speculators. The mechanisms used by speculators to attack a pegged currency are examined alongside the various defence mechanisms routinely used by countries to protect their currency. The case that Scotland would be unable to defend its own currency when other similar sized countries do so successfully is dismissed.

The case for Scottish independence must be made in as “future neutral” a manner possible. Post-independence, all political parties must be able to enact their preferred manifestos without being “locked in” to futures dictated by the course of the independence referendum. A Scottish currency offers this possibility far more readily than any other currency option.

**Key Points:-**

1. Sterlingisation would lock Scotland into a particular set of policies for over a decade post-independence. A Scottish currency offers a “future neutral” approach to policymaking.

2. A Scottish currency may be launched during a three year transition period between an independence referendum and formal political independence. This enables the currency and Central Bank to be set up whilst still under the support of the Bank of England.

3. Post-Independence, it would be for the government of the day to decide Scotland's monetary policy. This may include maintaining a currency peg with the UK Sterling, it may include shifting the peg to another currency, or dropping it altogether.

4. A pegged currency may be adjusted rapidly – within hours – in the event of a crisis. A Sterlingised Scotland would not be able to launch a new currency if one was needed to protect Scotland in the event of an external shock such as a financial crash in London.

5. Pegged currencies are sometimes said to be vulnerable to speculative attack but this potential vulnerability is countered by confident governance, a willingness to defend the peg and use of policy tools such as adjusting interest rates and foreign reserve levels.
Introduction

Currency remains one of the foremost topics of discussion around the Scottish independence debate. Many of the arguments for or against each of the reasonable options are now very well rehearsed and Common Weal’s contributions to the debate in terms of laying out the options1, discussing how a currency should be created2, ensuring it is sufficiently backed by foreign reserve assets3, and creating a central bank to support it4 form a now well known and respected corpus of political research.

This body of research forms an integral part of Common Weal’s overall prospectus5 for the design of an independent Scotland and the roadmap for transition from a devolved member of the United Kingdom into an independent state.

This vision is not the only one to advocate for an independent Scotland nor to lay out what an independent Scotland could look like. In May 2018 the SNP-commissioned Sustainable Growth Commission published its own proposal for the early years of an independent Scotland. This report has been described as a discussion document and does not yet form official SNP policy as it is to be debated at a series of National Assemblies and then approved, amended or rejected by the party’s autumn conference.

Key to the Growth Commission’s proposal is a plan for an independent Scotland to unofficially continue to use the UK pound sterling in a process of currency substitution often known as Sterlingisation6. Common Weal has published a detailed objection to these proposals elsewhere7 and they will be only briefly summarised here. The primary purpose of this report is to gather our collected work on currency into one document and to clearly lay out not just why Common Weal believes that an independent Scotland should begin life with an independent currency but also to lay out the process by which this could be achieved.

By contrasting our proposals with those of the Growth Commission’s (and that report’s implied process for transitioning to a Scottish currency at some point post-independence), it is hoped that the two proposals may be directly compared, discussed and ultimately one of them selected as the preferred campaigning position for the independence movement.

Why Scotland needs an independent currency

Common Weal published a paper in July 20168 examining the reasonable options ahead of Scotland with regard to currency on day one of independence. Of these, a currency option was ruled out as being subject to UK Government veto as well as possibly causing problems for Scotland’s re-admission into the EU and entry into the Eurozone ruled out as impossible on such a short timescale (given that Eurozone entry requires the use of a sovereign currency and its linking to the Euro via the European Exchange Rate Mechanism for a period of not less than three years). This leaves only the two options of an independent currency or currency substitution by means of unofficially using Sterling or the Euro (of which the latter is unlikely if only for the reasons of familiarity and continuity of pricing).

Whilst the Growth Commission has chosen Sterlingisation on the basis that it offers stability of pricing, continuity and familiarity whilst protecting savings and liabilities such as cross-border pensions and mortgages. They also state that, in their view, the country could transition to an independent Scottish currency in due time and subject to the meeting of “six tests” regarding the Scottish economy and fiscal policies. The Commission envisages that it may take around ten years for Scotland to meet the tests laid out by the report, only after which could the country consider launching its own currency.

Common Weal’s view is that Sterlingising Scotland in this way risks preventing the country from using key macroeconomic powers in the early days of independence at a time where their use would be extremely important. Tying the Sterlingisation process to the “six tests” would, in particular, shackle the Scottish economy to the economy of the rest of the UK and puts the Scottish government at significant risk of having Austerity imposed on it – regardless of the intentions of the Scottish Government – by a combination of the application of the fiscal restraints mandated by the “six tests” and on the instruction of City of London financiers who may be a significant source of the Sterling that Scotland would have to borrow in lieu of having the power to create its own currency as required. If an independent Scotland wants the greatest possible set of fiscal and macroeconomic tools available to it at the point of independence then it needs to launch an independent Scottish currency.

How to launch a currency

The process of launching a currency is one which cannot be rushed and can be complex in that it involves many interlocking and interconnected steps but it is not a task that Scotland is incapable of undertaking successfully – many other countries have launched currencies upon their independence and have done so under circumstances far
more fraught and unstable than Scotland’s transition to independence is ever likely to be.

The setting up of a currency in an orderly fashion so that it is fully operational by the time of independence is likely to dictate the timing of independence itself. The transition would be best implemented during the period between an independence referendum and formal independence day itself. The experience of launching the euro – on which the plan outlined by Common Weal is largely based – indicates that the design and launch of a currency is essentially a three year process. This indicates that the transition period between referendum and independence day should itself be a three year process. Whilst this is significantly longer than the 18 month period posited during the 2014 independence campaign, the experience of the UK’s exiting the EU indicates that the two year time period between the triggering of Article 50 of the Treaty of the European Union by the UK Government and the UK’s intended leaving date is proving to be a very restricted period within which to conduct the necessary negotiations. As Scotland is rather more immersed within the structures of the UK than the UK is within the structures of the EU, this extended three year timetable appears to be more reasonable than a shorter one. The three year timeline is explored in detail in Common Weal’s book How to Start a New Country but a summary version would be as follows.


Shortly after a referendum in favour of Scottish independence there must be a recruitment drive to ensure that people with the skills to implement the process and to manage it thereafter are in place. Ideally, this recruitment process could start before the referendum, with key people identified and approached – at least privately – long before a formal offer is made. A National Commission should be formed which will co-ordinate not just the launch of the currency but the building of the other institutions required by an independent Scotland (the existing civil service and politicians would therefore be able to continue in their current roles as few would have the spare capacity to take on the extra work without disruption). This would also include the founding of a Scottish Central Bank and the recruitment of key personnel including its governor, directors for the policy and implementation board and a stakeholder board to represent wider Scottish interests. One of the first duties of the Scottish Central Bank will be to begin the process of building a sufficiency of foreign currency reserves for the support of the Scottish currency post-independence. Another early task will be to begin designing the financial regulation system that the Central Bank will be responsible for overseeing. If Scotland wishes to rapidly rejoin the European Union upon independence then these rules must, at a minimum, comply with the Aquis Communautaire (the set of rules and regulations with which prospective EU members must comply before they may join the EU) but otherwise there would be a substantial advantage to be gained by reviewing the failings of the UK’s financial regulatory sector and to avoid repeating these failings either by design or by simply copying the UK rules into Scotland’s system without review.

Around this time, a public consultation should be launched to design the physical notes and coins of the new currency (as well, potentially, as its name). The icons, symbols and people displayed on notes and coins can be powerful forms of identity building, can foster a sense of “buy-in” to the project and can be a powerful outward expression of the attitudes and outlooks of a neonatal nation. However, the shape, size and mass of the notes and coins of the physical currency need to be taken into account when modifying devices such as tills, ATMs and vending machines so this process must begin fairly early in the process to allow for adequate time for conversion once the design is determined.

The currency would be launched as a digital unit of account at this time. It would not, at this stage, operate as a tradable currency – nor would any trade be possible given that no money would yet have been created – but the creation of the digital unit would allow banks, shops and other institutions to begin the process of updating their IT systems to be able to handle the new currency when it becomes available. The digital unit would be set on par with the UK pound sterling such that one unit of Scottish currency would equal one pound Sterling. This offers a sense of price continuity and stability throughout the transition process and recognises the close economic ties that Scotland would initially have with the remainder of the UK in the early days of independence.

By the end of year one, banks and other institutions will have reformed their payments systems and upgraded their infrastructure to the point where they would be able to offer services denominated in the new currency as well as in Sterling or any other currencies in which they already habitually operate.

2. Year 2 – Transfer and Transition

By the start of year two, banks will be able to offer new bank accounts denominated in the new currency to users and businesses. New accounts are vital as, with the exception of a very few, very new types of banking, almost all existing bank accounts held in Scotland are denominated in Sterling only. If a user transfers other currencies like US dollars to the account then the bank will convert them to Sterling before depositing them (usually after charging a transaction fee). Those who open Scottish currency accounts would be given the opportunity to purchase Scottish currency from the Scottish Central Bank at the pegged value of 1:1 with regard to the £Sterling.

It is a foundational principle that throughout the transition process, there is applied a rule known as “no compulsion, no prohibition”. What this means is that no bank customer would be forced to open a Scottish currency bank account nor would they be prevented from opening one should they request it. Nor, at any time, would a Scottish resident be forced to sell Sterling to purchase Scottish currency or otherwise translate their savings into the new currency.
The importance of this principle is illustrated by the impact of the rule on the supply and demand of the currency. If, for example, roughly half of the Scottish population were enthusiastic about the new currency but the other half were sceptical and the whole population was compelled to convert their savings then those who did not want to do so may immediately sell their Scottish currency and re-purchase Sterling. This would flood the trading market with unwanted Scottish currency and cause its value to drop. However if the “no compulsion, no prohibition” rule is applied than only those who want the currency immediately will purchase it leading to demand for the new currency being matched by the supply of currency created by the Central Bank.

There may be a concern that banks would refuse to offer the required financial services but the realities of competition in the market are that if a particular bank does not want to count Scottish citizens amongst their customers then one of their competitors will. The market could also be sufficiently secured by the presence of a robust publicly owned retail bank and by offering support to those small Scottish banks and credit unions which may need additional help to convert and upgrade their systems.

Around this time, shops and businesses which have already upgraded to allow transactions in the new currency may start to offer dual pricing in Scottish currency and Sterling. This is already a familiar process in many parts of the world which either lie on currency borders or experience a large volume of multi-currency trade (Geneva in Switzerland is a good example of this where prices are often displayed and payable in Euros alongside the official Swiss Franc). Again, due to the parity in value between the two currencies, no price conversion will be required as was the case during, for example, the 1971 decimalisation of the UK currency.

3. Year 3 – Tax and Spend

By the start of year three, the Scottish Central Bank should be fully operational. Both it, Revenue Scotland and other related institutions will begin to carry out functions relating to the new currency. For the Central Bank, this will involve money creation, clearing functions, investments and financial regulations as well as statistical operations. Many of these operations would be profit generating endeavours. The Scottish Central Bank could be expected to generate £30-£50 million per year in the seigniorage of new currency issue. Clearing functions and the selling of statistical data and other services would ensure that the Bank would run at a profit overall. As Scotland would still be a member nation of the United Kingdom at this point, many significant macroeconomic functions would still lie with the Bank of England. In these cases, the Scottish Central Bank would shadow the BoE’s operations and ensure that their own systems match the capability required to take them over. This period will also be used by banks and other institutions to bugfix their systems by shadowing counterpart organisations.

By this point, a substantial fraction of people in Scotland will have the ability to handle the new currency and the Scottish Government could now offer the ability to collect taxes (particularly devolved and local taxes) or to pay out social security in the new currency. Public sector workers may also request to have their salary (or a part of it) paid in the new currency. This could later be extended to private companies too though the “no compulsion, no prohibition” process would remain throughout. Schemes may be put in place to ensure a smooth transition for people with liabilities currently denominated in Sterling. An example already established in UK law is the Mortgage Credit Directive which mandates that banks must offer protections to customers whose mortgage is denominated in a currency other than the currency of the user’s income or residence (at the moment, this is usually aimed at customers who own homes outside of the UK). Measures mandated by the MCD include measures are in place to limit the risk that customers become exposed to changes in exchange rate up to and including giving customers the right to re-denominate their mortgage into an alternative currency. Similar measures could be introduced to support other debts or liabilities such as pensions.

At some point during year three, as early as possible and certainly not later than six months before independence day, the physical currency design process will be completed and the Royal Mint could be commissioned to mint the coins (the Royal Mint produces coins for more than 60 countries and produces more coins for export outside of the UK than it produces for domestic use) and companies such as the UK’s De La Rue, the Dutch company Gemalto or the Germany company Giesecke & Devrient would be commissioned to produce banknotes. Once the physical designs are finalised, upgrades can be made to devices such as tills, scanners, ATMs and vending machines (a task which is substantial but also fairly routine as notes and coins are individually replaced every few years already).

4. Independence Day Onwards

Three years after the referendum on Scottish independence, Scotland would become an independent country once again. All of the infrastructure required to run that country will now be in place, will have been shadowing equivalent UK structures where appropriate and will be ready to seamlessly take over responsibilities. The Scottish currency becomes Scotland’s official currency for the purpose of trading and accounts. Taxation, social security and similar payments must now be paid in Scottish currency. There will still be no compulsion and no prohibition on the part of businesses and people to hold Scottish currency or to give up Sterling – indeed, people and businesses who conduct a significant amount of cross-border trade or business will almost certainly maintain holdings in multiple currencies in much the same way that many people and companies routinely deal in US dollars, euros or other currencies at the moment.
Sterlingisation – A Silver Chain

The currency plans suggested by the Sustainable Growth Commission run in stark contrast to the above proposals by not offering a “future neutral” approach to currency nor on macroeconomic policy.

A more comprehensive critique of the Growth Commission’s approach to currency – that is, to unilaterally continue to use Sterling without a currency union or input into Bank of England macroeconomic decisions, is published in Common Weal’s policy paper ‘A Silver Chain’ but it can be outlined in this report.

The principle outward objection to the proposal is that it would not just preclude Scotland from having any control over macroeconomic policy (indeed, it would result in Scotland having less influence over macroeconomic policy than it has at present as independence would remove Scotland’s political influence from the UK and Sterlingisation would remove the obligation the Bank of England has to consider Scotland’s economic situation when making macroeconomic decisions) but it would leave Scotland vulnerable to the London financial sector either by conditions set by lenders or the precipitation of an outright liquidity crisis should another Financial Crisis affect London.

More fundamental to this outward objection is the semi-permanent nature of the proposals as stated. The Growth Commission sets a series of “six tests” which should be met before a transition away from Sterlingisation and towards an independent currency. However, it does not mandate a timeline towards this transition nor does it mandate that a future Scottish Government should attempt to meet the tests. The full critique lays out why attempting to meet the tests may themselves be detrimental to the Scottish economy (thus impossible, in practice, to achieve). Even if this was not the case, without the clear impetus to attempt to meet the tests there can be no assumption that Scotland would ever actually transition to an independent currency.

The infrastructure proposed to prepare Scotland for Sterlingisation also lends itself to a semi-permanent currency arrangement rather than a time-limited transitional one. In particular, the acceptance that an independent Scotland would adopt the UK’s financial regulatory framework wholesale would introduce a great deal of political inertia should there be an attempt to change this later.

If the Growth Commission (or another party) was to advocate for a strictly time-limited transition to a Scottish currency post-independence but Sterlingising in the period between independence and the currency launch then the structures set up to support this plan would reflect that time-limited nature. There would be a clear timeline of the events that would occur during the transition along with keystones points to be reached along the way (such as the time by which the Central Bank would be expanded to take on the full functions expected of it). At the very least, the tests required before a currency is launched would be expected to be framed as targets to meet rather than barriers to be overcome and the clear policy direction from the Scottish Government would be that there would be a proactive effort made to meet the targets.

It may well be that the politics of independence and the circumstances by which Scotland becomes independent dictate that the patient, three year transition period outlined by Common Weal is not possible. If a rapid progression from referendum to independence is the goal or result (perhaps following the 18 month timeline indicated during the 2014 independence campaign) then there would not be time to set up and launch a new currency for day one of independence. Instead the timeline indicated above would need to be continued beyond independence day and it is probable that a form of Sterlingisation would be used in the interim. Again, this proposal could and should be laid out clearly and well ahead of the referendum.

How to Launch a Currency Later

For clarity, the Sterlingisation proposal laid out by the Sustainable Growth Commission is not a short-term or temporary transitional arrangement which will, in itself, automatically lead to a Scottish currency. Should an independent Scotland begin life as a Sterlingised country and should it desire to create an independent currency then the process for transitioning to that currency will take a somewhat different form to the one outlined above.

First, if the Growth Commission’s proposals are adopted in full then Scotland would have to meet the “six tests” before a Scottish currency would begin to be considered as a possible policy option. Unless there was a sustained and deliberate effort made by Scotland to meet those tests then Sterlingisation would remain as the default monetary policy until an external event forced the tests to be met.

This could occur if, for example, a financial crisis in London triggered a recession in rUK and suddenly decoupled Scotland’s economic cycle from that of the UK’s.

As noted above, if Scotland had its own currency at this point and was pegged to Sterling, then there could be a decision made quickly to adjust or remove the peg and adjust interest rates in order to protect Scotland from the effects of that recession.

As a Sterlingised country, however, Scotland would have to actively decide that now would be the time to launch a currency. This may or may not be in line with manifesto promises made at the previous election (one could envisage a Scottish Government winning an election on a manifesto stance to maintain Sterlingisation for the duration
Defending a Currency – How to protect against a speculative attack

The prospect of Scotland being in control of its own affairs, including launching and managing its own currency, can appear daunting to some. The fear of Scotland being at the mercy of ruthless financial speculators is understandable, but the assumption that the solution to this problem is to hold tight to the monetary policy of a country which has done much to foster, encourage and – indeed – become economically reliant on that kind of financial speculation is naivety. Particularly not when the lessons of 1992’s “Black Wednesday”, the 2008 Financial Crisis and the 2016 devaluation following the EU Referendum have shown that the UK is neither immune to these risks nor is it particularly adept at managing its way through them.

Nevertheless, if Scotland is to maintain its own currency and especially if that currency is to be pegged to the UK Sterling for any length of time post-independence then it is important to understand the causes of speculative attacks on currencies as well as the preventative and defensive measures that a country can mount against them.
1. What is a speculative attack?

As of 2018, many currencies in the world are "freely floating", which means the value of the currency is not based on the value of a precious metal – such as gold or silver – but are based on the value set by “the market” of traders buying and selling the currency as well as the fundamental strength of the underlying economy which uses the currency. A “pegged” currency, by contrast, takes the form of a fixed ratio or is constrained to strengthen or weaken in relation to that currency only within a certain bound.

However, if the peg is set at a value that is widely believed to be “wrong” for the economy in question then there is the possibility that financial speculators may attack the currency in an attempt to “break” the peg. If they are successful, the speculators stand to make a substantial profit by doing so.

In a classic speculative attack, the currency is judged to be “overvalued” compared to its pegged value (this was the case with Sterling during the 1992 “Black Wednesday” attack which caused the Sterling to delink from the European Exchange Rate Mechanism). In this case speculators will attempt to “short” the currency. They do this by borrowing the target currency and selling it for some other currency (such as dollars or euros). If the over-supply of currency for sale on the market outstrips demand, then the price of the currency tends to decline. The speculators hope that the price decline becomes large enough and lasts long enough that they are then able to sell their dollars etc and buy the target currency at the new, lower price. They are then able to pay back their loan with their overall profit being the difference in exchange rates before and after the price drop, minus the interest paid on their loan and plus the interest gained by holding the dollars etc in the interim.

It is also possible to mount an attack if the currency is considered undervalued compared to its peg (currencies can be pegged low in order to make exported goods more competitive). The principle of the attack is fundamentally the reverse of the above with speculators borrowing dollars etc and selling them to purchase the target currency. This lowers supply and increases demand which pushes up the price of future purchases. If the increased price is allowed to stand then the speculator can sell their holdings of the target currency at the higher price and pay back their loans – profiting from the difference.

2. How to defend a currency

It is far from inevitable that an attack on a pegged currency will succeed. In the event of a speculative attack there are essentially three outcomes depending on the reaction of the target country's government and central bank.

The country may mount a defence of the attack which may succeed or it may fail. Alternatively, the country may decide to not mount a defence at all and allow the peg to drop and the currency to find its new value. Currencies that are not pegged to another currency are not usually seen as being vulnerable to an attack in the sense that the market’s attempts to affect the rate is seen as a desired outcome. If the currency is over or under valued then the market will readjust the rate and a defence not usually mounted. This was seen in the UK after the 2016 EU referendum where the value of the Sterling dropped by around 8% with respect to the US dollar – the third largest one-day fall in value of any major currency in recent history and a drop around twice as deep as the one felt during the 1992 “Black Wednesday” event. This drop had and continues to have had significant effect on the UK economy but has had a far less damaging effect on UK politics as was felt in 1992.

The decision to defend or not to defend against an attack is not a trivial one. The price of a defence, even a successful one, can take the form of higher interest rates – which can result in an economic shock and a rise in unemployment - and depleted foreign exchange reserves – which can reduce reliance against a future attack or emergency should one occur before reserves are rebuilt. There is also the cost of rebuilding the reserves themselves to consider.

On the other hand, a successful defence can be a sign of a stable government and resilient economy. In many historical cases, a successful defence of a speculative attack has had the effect of improving the economy of the target country as confidence in the governance of the country is improved by the success.

Despite the UK’s memory of “Black Wednesday”, it is not a simple given that countries will be unable to defend against speculative attacks. A study of 163 speculative attacks during the years between 1960 and 2011 found that 42 were not defended against, 87 experienced successful defences and only 34 resulted in unsuccessful defences. Unsuccessful defences, in fact, represent only a minority of cases.

However, the decision to defend against an attack is not without risks. Whilst abstention from an attack can have moderately negative effects on the economy of the country, an unsuccessful defence can have profound implications depending on how heavily the government fights its war of attrition before admitting defeat. Foreign exchange reserves may become severely depleted or even drained completely (governments may incur significant debts if it begins to borrow money to maintain the defence beyond this point). Interest rates may rise to the point of triggering a recession. The unsuccessful “Black Wednesday” defence mounted by the UK was estimated to have caused an output gap in the UK’s economy equivalent to around 4% of GDP and had profound impacts on both national politics and national psychology which may have fundamentally altered the relationship the UK had with Europe and the Single Market from then on. It certainly played a very large role in Gordon Brown’s decision to effectively block the UK’s entry into the Eurozone by the implementation of his “five economic tests” and the event continues to cast its shadow over the currency debate playing out in the Scottish constitutional question more than two decades on.
So the trial faced by governments when under attack ultimately lies in how likely they think they are to successfully defend the currency. If they are not confident, then capitulation is the rational choice as it will do less damage than failure will. But a successful defence is the least damaging option of all – indeed, a confident willingness to defend a currency can, itself, be a defence and deterrent as a successful defence will result in substantial losses for the speculators who take part in the attack.

In a classic example where the currency is seen as overvalued central banks have two principle policy levers that they can use to stave off an attack. The first is to raise interest rates. This has the effect of making it more expensive to borrow currency and can make it harder to buy (as those who already hold it are incentivised to keep it). If interest rates are held high enough for long enough, it can render the attack on the currency unprofitable and speculators will back off.

The downside of this move is that it increases interest rates across the whole economy which can have an adverse effect on people with debts (such as mortgage holders or businesses seeking to take out loans to expand) whilst having – at least in the short term – a beneficial effect for people with savings. If interest rates rise too high or too sharply it can cause a shock in the economy which may result in price rises and unemployment.

The second major tool available to central banks is to draw upon the country’s foreign reserves. As the speculators borrow the target currency, the central bank can sell its reserves of dollars, euros or other currencies and use them to buy back its own currency from the market. This reduces the supply of the currency and makes it more expensive for speculators to borrow. If the currency trades in relatively low volumes (i.e. is not a major reserve currency like the US dollar or the euro) it may even make it difficult to borrow enough currency to mount the attack. This method may seem therefore to be limited by the amount of foreign reserves that a country is able to accumulate before the attack. In the past, this was indeed the case though in more recent years the financial sector has grown more sophisticated and central banks have increased their lines of communication between each other. If a country is in danger of depleting its foreign reserves due to an attack but is still willing to defend it and the fundamentals of its economy remain strong then it is possible for countries to borrow foreign reserve currencies or to open “swap lines” with other central banks (whereby the banks swap amounts of their respective currencies at agreed rates) which can allow banks to continue their defence. This mutual arrangement allows countries to reduce the amount of reserves they hold and allows the funds to be invested in the economy rather than sitting dormant.

It may be that the former method of defence, by raising interest rates, is more effective than selling reserves though in practice both tools can be used.

The case of an undervalued currency is subject to less attention often because of the very human psychological attraction of equating a “strong” currency with a virile economy (though the truth is that an overly strong currency can be just as damaging as an overly weak one as the domestic economy becomes uncompetitive compared to cheap imports). There is also the point that whilst the tools used to defend a weak peg are the inverse of those used to defend a strong peg, the impact and limits of them are different.

Against a weak peg, the central bank would reduce interest rates in the face of an attack though it can usually only do so to the point that they hit 0%. Negative interest rates are possible but these, in effect, cause savers to lose money and debtors to see their liabilities eroded without having to pay them back (which may encourage excess borrowing and inflated house prices as people take on larger mortgages). Whilst not necessarily an invalid economic model – as the experience of Denmark has shown it is a very different one from the one we currently generally maintain.

Defending a weak peg via foreign exchange reserves also operates in the inverse manner to the defence of an overly strong peg. The Central Bank sells domestic currency to increase supply in the market and uses it to purchase foreign currency (which can be placed in the foreign exchange reserve or can be invested in foreign assets). The principle difference is that the Central Bank has monopoly control over the supply of domestic currency and can create money as required to defend the peg. There is therefore no danger of the foreign exchange reserve becoming depleted or there being a hard limit to the extent to which the peg can be defended (which is why speculative attacks more often target strong pegs and try to devalue currency rather than the opposite). Denmark is again the object example of this process taking place. Its currency, the krone, is tightly pegged to the euro but has, in recent years, shown a tendency to try to appreciate. The defence of the peg using both interest rates and foreign reserve purchases has contributed to Denmark inflating its foreign reserve to a comparatively large 20% of GDP (compared to Sweden’s reserves of around 10% and the UK’s 5% of GDP).

3. How vulnerable is Scotland to a speculative attack?

There are two regimes to consider when assessing the vulnerability of Scotland’s currency to a speculative attack. This first is in the early period of independence – during the transition to independence and in the first few years afterwards. This is when Scotland’s institutions are at their most vulnerable as they would be in the process of being set up. Much of this risk can be mitigated by following Common Weal’s plan of setting up the currency during the transition period between a referendum and independence day. This ensures that the Bank of England remains responsible for managing macroeconomic policy until such time as the Scottish Central Bank can take over full functions. If the transition to a Scottish currency was to come later – perhaps after a lengthy period of
Sterlingisation - then the Scottish monetary institute would have to expand into its capacity as a full central bank at the same time as trying to manage the Scottish economy. The Growth Commission’s test on foreign reserve adequacy is a particular concern here as the level of reserves deemed adequate for a Sterlingised economy may be significantly different from those required for a pegged currency (or a freely floating one). As outlined in Common Weal’s previous critique23 of the Growth Commission's plans, if a significant mismatch between desired reserve levels exist then it may be difficult to match the reserves in preparation for the transition. If the reserve levels required for an independent currency are much lower than those required for Sterlingisation then this would imply that Scotland would naturally meet the Growth Commission target (which would beg the question, why Sterlingise in the first place?) and may result in complications in the future as Scotland would likely seek to sell off the excess reserves.

If the level of reserves deemed adequate for Sterlingisation are lower than those required for the new currency then it may become difficult or impossible to transition to a new currency without direct and concerted effort to do so. Raising reserve levels in a regime where the country cannot create new money (as would be the case under Sterlingisation) implies that the money must be extracted from the economy (by running trade or government surpluses) which may have a detrimental effect on economic stability. As the Scottish Monetary Institute would have no income from seigniorage and would very likely have a limited revenue stream from services such as bank clearing (many of these functions would be undertaken by the Bank of England), there would be little opportunity to invest surpluses from the institute into the foreign exchange reserves.

The Scottish government already comes under perennial criticism24, 25, 26 for running a government surplus on the order of a few hundred million pounds. These “budget underspends” are largely due to accounting methods and, for the most part, do not represent “real” funds which can be redeployed into government spending (though that fraction which is “real” is carried over to subsequent budgets and spent the following year). The money diverted towards building a foreign reserve would represent “real” funds thus it can be expected that there will be substantial political opposition towards channelling of such funding into a largely dormant reserve instead of into other public spending. If the Scottish Government relied entirely on the redeemable cash from underspends (around £66 million in 201826) then it could take many decades to build up the reserves required to sustain an independent currency.

Regardless of the method by which Scotland launches its currency – which determines how difficult it would be to defend against an attack – there are signals that determine how vulnerable a currency peg is to attack in the first place.

One of the principle vulnerabilities lies in “mispricing” of the peg. Whether by economic divergence or a deliberate (though generally unwise) effort to change the peg for political gain. One could imagine a country deliberately pegging their currency to a weaker one or pegging at an understated ratio (say, 1 Scottish Pound = 0.9 UK Pounds) in order to try to boost export competitiveness.

If, however, the peg is set appropriately to the economy and is simply there to reduce day-to-day volatility then currency speculation would be extremely unlikely as any attempt to devalue to the currency would not be able to change the value of the currency enough to yield substantial profits for the speculator.

How the economy of an independent Scotland will diverge from that of the remainder of the UK is inherently unknowable – especially with the prospect of an uncontrolled Brexit on the horizon – but the argument that a parity (i.e. 1:1) peg between a Scottish currency and the UK Sterling is inappropriate in the short term cannot be maintained alongside either the argument for Sterlingisation or the argument that Scotland should remain with the UK unitary state as to do so would be to claim that either of those two positions (and especially the latter) would result in Scotland using a currency the value of which was inappropriate for its economy. Until such an economic divergence takes place, Scotland would not be vulnerable to a speculative attack on a pegged currency based on the inherent value of the currency.

An attack may be possible based on the belief that the new Scottish government was too weak, too incoherent or simply unwilling to defend a peg. If this was the case then the rational course of action for such a government would be to not defend the peg and simply allow the currency to revalue at the point of an attack or pre-emptively float the currency to avoid the attack in the first place. If the government did believe itself to be strong enough or willing enough to defend the peg then its willingness to defend the peg would itself act as a deterrent to the attack. Laying down sufficient foreign reserves and spending the transition period and early years of independence building strong relations with other central banks and financial organisations (especially the Bank of England and ECB who will be reliant on a liquid supply of Scottish currency with which to conduct trade with Scotland) will add further robustness to the system as they could later be relied upon to swap or loan currency as required to maintain a stable financial system.

Also important will be the building of confidence in using the new currency. Fiat currencies are only ever as strong as the confidence people have in using them so it is important that Scotland builds up a robust portfolio of assets and contracts denominated in its independent currency. Institutions such as the Scottish National Investment Bank27 and Scottish National Infrastructure Company28 may be used to this end by securing and developing large public procurement projects, especially projects with meaningful value. Social housing is a particularly good example of this kind of project as they tend to attract high levels of investment, are generally considered to be worthy of high credit ratings and tend to support extended and diverse supply chains which means that the use of the currency spreads quickly throughout the economy. A currency that
is widely used, is embedded within the “real” economy and is protected by a sufficiently robust financial regulatory regime and a central bank strong enough to enforce it would be a currency simply not worth trying to attack.

Conclusion

There are essentially only three reasonable currency options that Scotland will have to choose from going into a future independence campaign. It may launch a Scottish currency for day one of independence; it may Sterlingise for a defined and temporary period whilst it is actively preparing a Scottish currency or it may follow the model advocated by the Sustainable Growth Commission of Sterlingising on a semi-permanent basis but with the option of perhaps launching a Scottish currency at some point in the future (almost certainly not less than 15 years from the point of independence itself).

It is clear that an independent Scotland with its own currency would have far more freedom to enact monetary and fiscal policy than under any other currency scheme and would be able to act to prevent financial crises as well as react to mitigate them. A Scotland without its own currency would have no powers over monetary policy and would find its fiscal policy severely constrained or even outright determined by events outwith its control (such as Austerity demanded by those who would loan Scotland the Sterling it needs to operate its economy).

The plan laid out in this paper shows how Scotland could have a fully operational currency ready by day one of independence. It also shows how a plan for temporary Sterlingisation could operate for a short time after independence until such a currency would be ready.

These two plans stand in contrast to the Growth Commission’s model of semi-permanent Sterlingisation which proposes no clear timeline to launching a Scottish currency.

The process of Scottish independence should be as “future neutral” as possible. It should not act in a way that compels or prevents a Scottish Government (particularly the first one post-independence) from enacting the policies on which it may be elected. If the Growth Commission’s policies on areas other than currencies (including those on fiscal constraint) are considered desirable then they could just as easily be enacted by an independent Scotland running its own currency as they could under Sterlingisation. However, there are many proposals for Scottish independence which could not be enacted under Sterlingisation, therefore this plan does not represent the fairest or most democratic option for a Scottish independence campaign.

An independent Scotland needs a Scottish currency on day one of independence or as soon as possible thereafter.
References

6. The Growth Commission disagrees with this term as it is would usually be applied to countries which gave up their sovereign currency in favour of Sterling whereas Scotland currently uses the Sterling officially. The mechanics of the outcome would be the same regardless. The term is therefore retained here for convenience.
H Macdonell, "Mackay Announces £66m is Left Over For Rainy Day", The Times, 22nd June, (2018)

