

What monetary arrangements for an independent Scotland?

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The possibility of Scotland's return to political independence raises the question: what sort of monetary arrangements would be most appropriate for an independent Scotland in the twenty-first century?

First, a bit of history. Before the union of the Scottish and English crowns in 1603, Scotland was on a silver standard with its own measure of silver, the Scots pound. The exchange rate between the Scots pound and the English pound was fixed at 12:1 in 1603. With the union of the Parliaments in 1707, the Scots pound was abolished as an official unit, although its private use persisted through the eighteenth century. Adam Smith thought it still relevant to report on the value of the Scots pound in his 1776 work, *The Wealth of Nations*. Smith also reported – favorably – on the system of private note-issue that had grown up in Scotland since the founding of the Bank of Scotland in 1695. Under Scotland's "free banking" system the exchange rate between Scottish notes and English notes, when both were redeemable for silver or gold coins, differed only trivially from par, being constrained within the narrow limits of the cost of shipping coin between Edinburgh and London.²

In 1797, with the onset of the Napoleonic Wars, the Bank of England suspended gold redeemability of its notes. It is a significant indicator of how closely the economies of Edinburgh and London were financially integrated that the Scottish banks followed suit and maintained parity with the paper Bank of England pound, rather than staying with gold and floating against the paper pound. (Ulster, by contrast, did stay with gold and floated against the paper pound.)

With the twentieth century's abolition of direct gold redeemability for the pound sterling and later the collapse of the international system of indirect redeemability known as the Bretton Woods system, the United Kingdom moved to a fiat pound sterling standard. Scottish banknotes today are denominated in fiat pounds sterling and are redeemable only for Bank of England notes and token coins. Thus Scotland today can be described as a "sterlingized" economy with local note issue.

Four options and three tests

The main monetary options for an independent Scotland would be: (1) continue on sterling, (2) switch to the euro, (3) launch a Scottish fiat currency, or (4) return to a

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² On the Scottish system before 1845 see Lawrence H. White, *Free Banking in Britain: Theory, Experience, and Debate, 1800-1845*, 2nd. ed. (London: Institute of Economic Affairs, 1995).

commodity standard (gold, silver, or a multi-commodity basket). Although gold and silver served an independent Scotland well in the past when the rest of the world was also on precious-metal standards, there is scant support for any variety of commodity money today, so we will move on to the other options. The Scottish National Party, the leading political force for independence, recommends that an independent Scotland should continue on sterling in the short run, but hold a referendum on switching to the euro in the medium run.

Economists analyzing a nation's choice among monetary regimes often refer to the theory of "optimum currency areas". OCA theory frames the choice of a monetary standard as a matter of weighing the benefits of having a local monetary policy which includes the option to devalue or depreciate the currency (taken to be an effective means for dampening business cycles), against the benefits of membership in a larger common currency area (lower transaction costs and lower risk in cross-border trade and investment).³ The theory dates back to the Keynesian era of the early 1960s, and thus predates the experiences and theoretical developments of the last forty years that have disillusioned most economists about central banks' ability to actually succeed at dampening business cycles. For an open economy with a great deal of cross-border trade and investment, the option to devalue carries a near-zero or even negative value, while the benefits of membership in a common currency are important and positive.

OCA theory approaches currency choice from the top down, viewing it as a choice to be made by government monetary authorities. The theory neglects the preferences of currency users, preferences that are most dramatically evident in countries where citizens spontaneously adopt a foreign currency (unofficially "dollarize" or "euroize" the economy). The theory also neglects the problem of constraining discretionary monetary policy to hold down inflation and inflation expectations. As I read it, the evidence indicates that money-users normally prefer a monetary unit (1) in which they can readily conduct a wide range of desired trades, and (2) that has stable purchasing power or low inflation. The first criterion explains why (for example) Latin Americans and Russians have widely adopted the US dollar rather than the world's currency with the best inflation track record, the Swiss Franc. The second criterion explains why Switzerland, a small open economy, declines to adopt the euro used by its neighbors (or even to join the EU): the euro is unlikely to be as trustworthy as the Swiss Franc.

Based on this reading of consumer preferences, joined with skepticism about the likelihood of successfully using an activist monetary policy to dampen (rather than to inadvertently amplify) business cycles, a three-part test seems appropriate for any currency offered as a candidate for Scotland's adoption. (1) How low are its entailed

³ MP Calum Macdonald (Western Isles), according to *Hansard* (11 Dec 1996, Column 352) declared in the British Parliament: "Likewise, no one can pretend that the highlands and islands in Scotland and the south-east of England share an optimal currency area--yet they share the pound, and both are affected by the decisions of the Chancellor and the Bank of England." But OCA theory does *not* say that two regions are better off using a common currency only if their economies are *perfectly* correlated.

transaction costs of changing money in order to transact with trading partners? (2) How high are the transitional costs of switching over to it? (3) How credible is its commitment to low inflation?

An independent new Scottish fiat currency?

A generation ago it was taken for granted that any self-respecting independent nation must have its own currency unit. Not any longer. In the first heady days of nationalist enthusiasm following the breakup of the Soviet Union, many once-again independent countries like the Baltic Republics launched their own local fiat monetary standards. Unstable inflation and volatile exchange rates soon led them to reconsider, and to fix their currencies to the dollar or the euro. The thirteen countries of the Eurozone (with more to be added) have given up monetary nationalism in favor of a transnational currency union.

Applying the transaction-cost test: An independent Scottish currency would clearly require more money-changing than either the continuation of sterling or the adoption of the euro.

Applying the switchover-cost test: Transitional costs would clearly be higher in switching to a new fiat currency unit than in remaining on sterling.⁴ The switchover costs to a Scottish pound could be somewhat lower than to the euro. They could be minimized by setting the new unit's initial value equal to £1 sterling, so that price tags and nominal contracts need not be renumbered at the transition date.

Applying the inflation credibility test: To make its fiat currency as credible as sterling or the euro, a new Scottish central bank would need a constitutional commitment to low inflation at least as firm as the Bank of England's or the European Central Bank's inflation-targeting regime. If Scotland could produce a commitment to low inflation just as low and just as credible as the Bank of England's, so that the inflation credibility test were a draw, the other two tests would become the decisive ones. With identical inflation rates and credibility, the potential gain to having a uniquely Scottish currency rather than using sterling would be limited to the – likely negligible – benefit gained by targeting the inflation rate within Scotland rather than the inflation rate within the current UK including Scotland (assuming that the Bank of England agrees to continue taking Scottish prices into account as part of the quid pro quo for Scotland remaining on sterling). Because low shipping costs insure that traded goods sell for nearly the same prices in Edinburgh and London, the Scottish and UK inflation rates are highly correlated today and would remain so under a continued common sterling standard.

⁴ Thus I agree with Willem H. Buiter when he writes: "The adoption of its own currency by Scotland would involve both giving up the microeconomic transaction cost savings from having a common currency with the UK, and incurring the switch over costs of establishing a new currency," with negligible scope for policy to provide macroeconomic stabilization. Willem H. Buiter, "Optimal Currency Areas: Sixth Royal Bank of Scotland / Scottish Economic Society Annual Lecture, 1999," *Scottish Journal of Political Economy* 47 (August 2000), p. 216.

To outweigh the convenience of sharing a common money, an independent Scottish central bank would have to be committed to lower inflation, or more credibly committed, than the Bank of England. It would have to be another Swiss National Bank. This would not be easy to accomplish. If it were easy, then other newly independent countries would have done it.

Could Scotland have the best of both worlds, independence and fixed exchange rates, by establishing a Scottish pound that would be pegged to sterling? No. An independent but pegged Scottish currency would, in fact, deliver the worst of both worlds. It would incur the switchover costs of setting up a new currency, and the inconveniences of money-changing at the border, but no better inflation performance than sterling. The risk of devaluation against sterling would hang like a sword over long-term contracts and investments in Scottish pounds, adding a premium to interest rates.

Sterling or euro?

Having dismissed the option of a commodity currency, and found the case for an independent Scottish fiat currency weak, we turn to the choice between the sterling standard and the euro standard.

Applying the transaction-cost test: It is clear that Scotland's trade is more highly integrated into the UK economy than into the Eurozone economy. According to input-output measures, Scotland's 2003 exports to rest of the UK were £35.9 billion, while its exports to the rest of the EU were £9.2 billion. (Scotland's exports to the entire rest of the world, EU included, were £19.5 billion.) Put another way, exports to the rest of the UK were nearly four times as great as exports to the Eurozone.⁵ This is no doubt largely for reasons of proximity and common language, factors that will not change with a change in the monetary regime. A sterling standard would thus allow Scotland to avoid money-changing costs for a far larger share of its trade than would a euro standard. Given its current trading (and labour mobility) patterns, Scotland is more naturally a member of the sterling network than of the euro network.

Applying the switchover-cost test: Remaining on sterling would also avoid the considerable transitional costs involved in switching to a different unit of account. As the countries adopting the euro have found, switching requires sizable one-time costs of reprinting price tags and menus, and of redenominating financial accounts.

Applying the inflation credibility test: How do the two currencies, sterling and euro, compare with regard to inflation and inflation credibility? Sterling inflation between 1999 and late 2007, as measured by monthly observation of the 12-month change (year-over-year) in the Consumer Prices Index (previously known as the Harmonised Index of Consumer Prices), has ranged between 0.8% to 2.5%.⁶

⁵ Source: Scottish Government input-output table at <http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/Input-Output/OutputSupply>)

⁶ Source: <http://www.statistics.gov.uk/STATBASE/tsdataset.asp?vlnk=340&More=N&All=Y>

Euro inflation, measured the same way over the same period, has ranged between 0.8% and 3.1%. It is currently 2.1%.⁷ Inflation is slightly higher in the euro than in sterling, but the difference of 30 basis points is trivial. On the other hand, nominal interest rates on ten-year government bonds have been 60-70 basis points higher in the UK than in the Eurozone.⁸ It is difficult to attribute this to anything but a lower market inflation-rate forecast for the euro over a ten-year horizon, or lower perceived risk surrounding the inflation forecast. The euro thus appears to have a very slight edge in inflation credibility.

Scottish participation in monetary policy-making under a sterling or euro standard

Under a sterling standard, monetary policy would come from the Bank of England; under a euro standard, from the European Central Bank. To what extent would Scotland participate in sterling or euro monetary policy-making? The arrangement upon joining the euro is presumably straightforward: Scotland would have a small voice, just as any other Eurozone member country does, in the ECB councils.

The possible arrangement of an independent Scotland with the Bank of England is less cut-and-dried. Because an independent Scotland could credibly threaten to leave sterling, it might be able to negotiate for a seat on the Bank of England's Monetary Policy Committee. Scotland could be officially represented on the MPC, much as the Federal Reserve Bank of New York has a permanent seat on the Federal Open Market Committee of the United States' Federal Reserve System. It is true that none of the seats on the MPC is currently regional, but that could be changed. The Bank of England has an incentive to agree to give Scotland a seat: it retains more seigniorage and more importance if Scotland remains on sterling. Should the Bank of England refuse Scotland a seat, that snub would not bode well for a sterling victory over the euro in a Scottish popular referendum.

It is true that there is no obvious precedent for giving an independent Scotland a seat on the MPC. Panama, after all, has been on the US dollar standard for more than a century without a seat at the table of the US Federal Open Market Committee. But Scotland is a much larger share of the sterling area, GDP-wise, than Panama is of the dollar area. And Scotland has historically been part of the UK, whereas Panama has never been part of the US.

Who will issue currency?

An independent Scotland would not need to nationalize the issue of banknotes under any monetary standard, just as it does not rely on the Bank of England to issue Scotland's common paper currency today. Private Scottish banks can continue to issue banknotes,

⁷ http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=122.ICP.M.U2.N.000000.4.ANR

⁸ Source: OECD Statistics v. 4.4 at <http://stats.oecd.org/wbos/>

obviating the need for government note-issue either by a central bank or by a currency board.⁹ Under a Scottish fiat standard, the private Scottish banks of issue would make their notes redeemable in Scottish Central Bank deposit liabilities and Scottish coin rather than Bank of England liabilities and British coin. Under a sterling standard, Scottish notes would continue to be payable to the bearer on demand in Bank of England liabilities, although the requirement that they be backed 100% by Bank of England liabilities (beyond an authorized unbacked issue) – a relic of the British Parliament’s Bank Notes (Scotland) Act of 1845 – would no longer apply.¹⁰ No similar reserve requirement need take its place. Without legal minimum reserve requirements, as in Canada today, banks prudentially hold the reserves necessary for customer redemptions and interbank settlements, that is, for paying off their claims to depositors and to one another.

On a euro standard, Scottish banks could continue to issue currency, now denominated in and payable to the bearer on demand in euros, only if the ECB would allow the continuation of local private note-issue as a condition of accession. The ECB likely would not allow it unless its constitution were amended. Professor Otmar Issing, while a Member of the Executive Board of the European Central Bank, wrote that under ECB rules “any attempt by the private sector to issue banknotes or coins is counterfeiting, a serious criminal offence.”¹¹ This implies that if Scotland (or the present-day UK) were to join the Eurozone under current rules, the banks of Scotland would lose the note-issuing rights that they currently enjoy.

Several things are at stake for Scotland in the retention of local private banknotes. There is the pride and tradition of having Scottish heroes (in recent years Robert the Bruce, Robert Burns, Lord Ilay, Lord Kelvin, Sir Walter Scott, Mary Slessor, Adam Smith) pictured on the currency. There is the principle of subsidiarity: if the EU were unwilling to yield on local banknote issue, it would be unlikely to yield on allowing other traditional Scottish institutions to persist. There is also a bit of “seigniorage” (the earnings from note-issue) for the Scottish banks of issue, which benefits not only bank shareholders but also benefits depositors and noteholders to the extent that competition compels banks to offer more interest and higher-quality notes. (Greater competition among Scottish note-issuers could be promoted by legally reopening entry into the field to banks other than the three that have retained their historical rights.) The earnings from banknote circulation arise from banks using their note liabilities (in addition to their deposit liabilities) to fund productive loans. Currency holding is “intermediated” into

⁹ A currency board is a government agency that issues local currency backed fully by external reserve currency assets, and plays no other central bank roles. Bill Jamieson, “For a Scots monetary policy, see... Ecuador?,” *Scotland on Sunday* (25 Feb. 2007), for some reason imagines an independent Scotland linking to a sterling standard by having a currency board. But Scotland is already linked to sterling without a currency board.

¹⁰ The text of the Act is available at <http://www.statutelaw.gov.uk/>.

¹¹ Otmar Issing, *Hayek, Currency Competition and European Monetary Union* (London: Institute of Economic Affairs, 2000).

capital formation, making the Scottish economy more productive.¹² Under a government central bank note monopoly, by contrast, currency holding is intermediated only into government debt.

Finally, for an economy on an external monetary standard, private banknotes are more reliable as claims to the external money than are local central bank or currency board notes. Suppose, for example, a continued sterling standard. A Scottish commercial bank that failed to redeem its notes or deposits at par in sterling could be sued. A government central bank or currency board that devalued against sterling could not. The importance of maintaining its reputation in a competitive environment would deter a commercial bank from acting in ways that might endanger its ability to maintain par redemption. A government monopoly faces no such reputational constraint, since its customers have nowhere else to turn.¹³

Will a Scottish central bank be needed for other purposes?

Whereas competing private banks can best issue currency, a cooperative banking institution – an industry association formed by the clearing banks – can best provide the other services that central banks typically provide. Those other services most prominently include payment processing, setting standards for commercial banks, and acting as a lender of last resort. Let's consider them in turn.¹⁴

In many nations, central banks maintain account balances that commercial banks hold as reserves and use for paying one another. Central banks also process cheque payments and run the daily clearing sessions where commercial banks compute and settle the net amounts that they owe one another. The typical central bank thus acts as a 'bankers' bank'. As in note-issue, central banks have historically taken on the role of a bankers' bank not because they are efficient at it, but because formerly private institutions have been nationalized or legally restricted. The Victorian Era banking authority Walter Bagehot summarized the legislative process that transformed the Bank of England into the bankers' bank this way: "our one-reserve system was not deliberately founded upon definite reasons; it was the gradual consequence of many singular events, and of an accumulation of legal privileges on a single bank which has not been altered, and which no one would now defend." As a more organically evolved system, Bagehot cited the

¹² Adam Smith praised this aspect of Scottish note-issue in *The Wealth of Nations* (1776), giving it credit for contributing to Scotland's rapid economic growth in the eighteenth century. For a recent study on the importance of private note-issue in promoting economic growth, see William D. Lastrapes and George Selgin, "Banknotes and Economic Growth," University of Georgia working paper (October 2007).

¹³ This argument is developed in greater detail in George Selgin & Lawrence H. White, "Credible Currency: A Constitutional Perspective," *Constitutional Political Economy* 16 (March 2005): 71-83, and Lawrence H. White and George Selgin, "Why Private Banks and Not Central Banks Should Issue Currency, Especially in Less Developed Countries," *The Library of Economics and Liberty Contributors' Forum* (19 April 2000), <http://www.econlib.org/library/Features/feature3.html>.

¹⁴ This section draws on Lawrence H. White, "In What Respects Will the Information Age Make Central Banks Obsolete?," *Cato Journal* 21 (Fall 2001): 219-26.

Scottish banking system of his day, where no single bank enjoyed special privileges and many banks participated in the clearing system as co-equals.

Banking supervision or regulation is sometimes administered by central banks, but not sometimes not. In many countries the supervisory authority is separate from the monetary authority. In “offshore” banking centers, like Jersey and Guernsey, Hong Kong, or the Cayman Islands, supervision by the chartering authority is minimal. An independent Scotland could take greater advantage of the tradition of Scottish banking expertise to become an offshore banking center for the remaining UK and for the EU. With regard to “onshore” or domestic banking, inefficient restrictions are best avoided: interest rate ceilings, geographic limits, reserve requirements, portfolio restrictions, mispriced deposit insurance. This leaves little, though not zero, for a supervisory body authority to do. The scope for efficient regulations is limited to those that are advantageous both to banks and to their customers. Such regulations can be contractually formulated and privately enforced. Bank clearinghouse associations, such as the body that has today become the Committee of Scottish Clearing Bankers, have historically found it useful to develop and to enforce solvency and liquidity standards on their member banks, to assure all the member banks that their clearing partners won't default on interbank payments. Clearinghouse membership then provides a credible "seal of approval" for depositors seeking a safe bank.

A common argument historically for having a central bank is that it was needed to play the safety-net role known as the ‘lender of last resort’, providing reserves to a bank that finds itself short. Today, however, a bank that finds itself unexpectedly short on reserves can usually turn to a thick market for short-term interbank loans. With Scotland on a sterling (or euro) standard, a Scottish bank can access the market for reserves in London (or Frankfurt). A problem remains only if there is a sudden shortage of reserves in the banking system as a whole (as happened recently in the case of Northern Rock). A sudden shortage implies either a spike in the public’s demand for reserve money, of the sort that occurs in a financial “panic,” or a sharp reduction in the central bank’s supply of bank reserves. The possibility of panic justifies having a central bank only if it can be shown that panics are more frequent and severe in countries without central banking than in countries with central banking. The evidence actually points the other way. Canada, for example, had no bank failures in the Great Depression, but did not establish a central bank until 1935. The near-laissez-faire offshore banking centers of Singapore and Hong Kong were free of panic in 1997 while the regulated onshore banking systems collapsed in Thailand, Malaysia, and the Phillipines. An official lender of last resort can unintentionally worsen the problem of banking panics if it makes explicit or implicit bailout guarantees that encourage banks to take undue risks. The second possibility – a reserve shortage due to sharply contractionary central bank monetary policy -- hardly justifies having a central bank; quite the contrary.

A proposal

An independent Scottish government would best serve its citizens by remaining on sterling for the time being, whether or not is able to secure representation on the Bank of

England's Monetary Policy Committee. It should continue to allow local private note-issue, but eliminate the 100% marginal sterling reserve requirement. It should leave the long run open by allowing free choice in currency. Let the public hold euros, dollars, or Swiss francs to whatever extent they want. Let them thereby vote with their pocketbooks. This flexibility will not itself lead to any violent change in the payments system: the leading Scottish banks already offer euro-denominated accounts, but sterling payments remain predominant within Scotland. Should the pound sterling weaken substantially in the future, however, free choice in currency would allow for a spontaneous transition to whatever currency standard the public then prefers.