



HM Treasury

FROM: NICK MACPHERSON

DATE: 11 FEBRUARY 2014

CHANCELLOR OF THE EXCHEQUER

cc Chief Secretary

SCOTLAND AND A CURRENCY UNION

I attach a paper by Treasury officials, *Scotland Analysis: Assessment of a sterling currency union*. I agree with its analysis and conclusions.

Currency unions between sovereign states are fraught with difficulty. They require extraordinary commitment, and a genuine desire to see closer union between the peoples involved. As the Treasury paper points out, the great thing about the sterling union between Scotland, Wales, Northern Ireland and England is that it has all the necessary ingredients: political union, economic integration and consent. What worries me about the Scottish Government's putative currency union is that it would take place against the background of a weakening union between the two countries, running counter to the direction of travel in the eurozone.

I would advise strongly against a currency union as currently advocated, if Scotland were to vote for independence. Why?

First, the Scottish Government is still leaving the option open of moving to a different currency option in the longer term. Successful currency unions are based on the near universal belief that they are irreversible. Imagine what would have happened to Greece two years ago if they had said they were contemplating reverting to the Drachma.

Secondly, Scotland's banking sector is far too big in relation to its national income, which means that there is a very real risk that the continuing UK would end up bearing most of the liquidity and solvency risk which it creates.

Thirdly, there is the problem of asymmetry. The continuing UK would be at risk of providing taxpayer support to the Scottish financial sector and sovereign. An independent Scottish state would not face the same risk as it is

inconceivable that a small economy could bail-out an economy nearly ten times its size. This asymmetry could only cause continuing UK problems unless Scotland is prepared to cede substantially more sovereignty on monetary and fiscal matters than any advocates of independence are currently contemplating.

Finally, Treasury analysis suggests that fiscal policy in Scotland and the rest of UK would become increasingly misaligned in the medium term. Of course, if the Scottish Government had demonstrated a strong commitment to a rigorous fiscal policy in recent months, it might be possible to discount this. But recent spending and tax commitments by the Scottish Government point in the opposite direction, as do their persistently optimistic projections of North Sea revenues, which are at odds not just with the Treasury but with the Office of Budget Responsibility and other credible independent forecasters.

There is a substantive point here. If the dashing of Scottish expectations were perpetually blamed on continuing UK intransigence within the currency union, relations between the nations of these islands would deteriorate, putting intolerable pressure on the currency union.

If you follow Treasury advice and this week rule out a currency union in the event of Scottish independence, you can expect the Scottish Government to threaten not to take on its share of the United Kingdom's debt. I do not believe this is a credible threat. First, the sooner an independent Scotland established economic credibility, the better it would be for its economic performance. An extensive wrangle about its share of the debt would increase uncertainty and hence its funding costs. Secondly, the debt is one of a number of issues which would have to be settled post independence, where the new Scottish state would require the cooperation of the international community including the continuing UK.

As for the impact of the threat, much will depend on the markets' assessment of the probability of a pro independence vote and the likelihood of the Scottish Government seeing the threat through. In the short run, any uptick in gilt yields is likely to be small. And in the worst case scenario, it is more than likely that the increase in funding costs, which the continuing UK would face, would

be smaller than that which would result from an ill thought out currency union with Scotland.

And so to sum up, I would advise you against entering into a currency union with an independent Scotland. There is no evidence that adequate proposals or policy changes to enable the formation of a currency union could be devised, agreed and implemented by both governments in the foreseeable future.

A handwritten signature in black ink that reads "Nick Rapson". The signature is written in a cursive style with a long horizontal stroke at the end.

SIR NICHOLAS MACPHERSON

Permanent Secretary to H M Treasury