CURRENCY OPTIONS FOR AN INDEPENDENT SCOTLAND

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PART A: THE TREASURY ADVICE AGAINST CURRENCY UNION

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Introduction

The recent debate on a currency union between the UK and an independent Scotland was triggered by Chancellor George Osborne's speech ruling it out, a stance backed by the leaders of the Labour and Liberal Parties. Chancellor Osborne then published a letter[1] from his Permanent Secretary summarizing Treasury advice on this matter. As such advice is normally kept confidential, it is fair to presume that Chancellor Osborne published it to explain his decision, that he felt that it addressed all key issues objectively and convincingly, and that senior Treasury officials had weighed up every word prior to its publication.

The Treasury letter therefore invites scrutiny, but this it cannot withstand:

1. It does not even address the question that it purports to answer: whether the currency union is in the interests of the UK, if Scotland voted for independence.
2. Its references to the Eurozone are misleading as guides to the prospects of a currency union with an independent Scotland.
3. Its claim that Scotland would be an unreliable partner in a currency union is unsubstantiated.
4. Its claim that Scotland's financial system is "far too big", and would therefore expose UK taxpayers to heavy burdens, is unsubstantiated.
5. Its claim that the "asymmetry" between the economies of rUK and Scotland makes the exposure of UK taxpayers to "Scotland's financial system and sovereign" especially inequitable is not merely unsubstantiated: it is the reverse of the truth.
6. Its claim that the likely misalignment of the fiscal policies of the UK and an independent Scotland would put "intolerable pressure" on the currency union is evasive — and unsubstantiated.
7. Claims (4) and (5) assume a legal framework for the currency union that is inconsistent with the framework assumed in claim (6), so these claims do not constitute cumulative arguments against a currency union.

These points are addressed in order in the following sections, which challenge each paragraph of the Treasury letter concerned with the currency union. The Treasury claims are invalidated, not by errors of fact, but by errors of logic. These errors are subtle and difficult to disentangle. But only subtle logical error could have led Treasury to claim, in effect, that past risky behaviour by investment bankers in London, inadequately supervised by the Bank of England, somehow disqualifies an independent Scotland to be a currency union partner of England.

There may be good reasons for the UK to reject a currency union with an independent Scotland, but none can be found in the Treasury letter. Yet, that letter is the key justification for the stance of the UK Government.

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[1] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/279460/Sir_Nicholas_Macpherson_-_Scotland_and_a_currency_union.pdf. See the Appendix

1. Treasury Answers the Wrong Question

T1. 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.

T2. I would advise strongly against a currency union as currently advocated, if Scotland were to vote for independence. Why?

Paragraph T1 compares the "sterling union between Scotland, Wales, Northern Ireland and England" with the "Scottish Government's putative currency union". If that were the issue facing the UK Chancellor, then Treasury need not have written its 76-page paper *Scotland Analysis: Assessment of a Sterling Currency Union*. It is obvious that the current "sterling union" is better for the rest of the UK (rUK) than the "Scottish Government's putative currency union". For, the latter will add no benefits to rUK, yet will certainly add transactions costs and microeconomic, macroeconomic and financial risks.

But the question raised in Paragraph T1 of whether to retain "the sterling union between Scotland, Wales, Northern Ireland and England" will be decided by Scotland's voters. The UK Chancellor has no standing in this decision. His duty is to answer the question raised by Paragraph T2: the best currency option for rUK "if Scotland were to vote for independence". The Treasury letter and paper never address this question. Instead, they address the question raised in Paragraph T1 — whose answer for rUK is obvious — while purporting to address the question raised in Paragraph T2 by advising "strongly against a currency union as currently advocated, if Scotland were to vote for independence".

"If Scotland were to vote for independence", then it must choose <u>some</u> currency option, be it currency union with the rUK, the euro, a currency board or a flexible exchange rate. The Treasury letter and paper never compare the impact on rUK of a currency union with the impact on rUK if Scotland instead chose one of these other currency options. The latter choices would almost certainly be worse for rUK, as I shall argue in Part B of this report.

First Minister Alex Salmond has been thrown on the defensive by the question: 'What is your Plan B for Scotland's currency, now that all major UK political parties have rejected a currency union?' He has a duty to Scotland's citizens to answer that question in detail. But meantime, he should ask Chancellor Osborne: 'What is your Plan B for Scotland's currency?' That is: 'Which currency option for an independent Scotland would be better for rUK than the currency union that you have rejected?' Chancellor Osborne has a duty to rUK citizens to answer that question in detail. Treasury has a duty to the Chancellor to compare in detail rUK's transactions costs and microeconomic, macroeconomic and financial risks under Scotland's various currency options. It has not done so.

2. Relevance of the Eurozone Experience

Paragraph T1 refers to the Eurozone experience as follows: "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." This suggests that the prospects for a currency union between Scotland and rUK are worse than for the Eurozone, which we know to be a fiasco.

The ease of cooperation between nations is determined by their distance apart — in terms of geography, history, culture, language and political tradition — not by their "direction of travel". Partners just starting to travel away from each other would find it easier to cooperate than partners who are far apart, although travelling toward each other. Scottish independence would rupture the political union with rUK, but that would still leave the two nations much closer than, say, Germany and Greece — in terms of geography, history, culture, language and political tradition; also, in terms of business, financial and fiscal systems. This would make a Scotland-rUK partnership much easier to manage than the Eurozone partnership, especially as the former comprises two countries, while the latter comprises eighteen.

In a recent speech[2], Bank of England Governor Mark Carney laid out a long list of requirements for a successful currency union, in particular, a tight banking union and tight fiscal rules. The Eurozone crisis reflects the difficulty of building from the ground up the requisite cross-national monetary, fiscal and bank supervision systems, especially as these have to be integrated with eighteen established national systems. Matters are much simpler for a currency union between just two countries that already share the systems that the Eurozone is struggling to unify across its members in the middle of a crisis. In other words, the common starting point of Scotland and rUK should more than offset any problems for their currency union that might arise from their "direction of travel".

In fact, the Eurozone crisis can be traced to the great distance between the political and business cultures of its northern and southern tiers, which resulted in very different macroeconomic and business structures and financial parameters. Currency unification removed exchange rate uncertainty, which had provided southern Europe a form of "trade protection" from northern Europe's superior productivity and international competitiveness. Currency unification also drove down the default premia and inflation premia built into the interest rates paid by southern businesses and governments. The result was that northern Europe ran large export surpluses with the south, which it lent back to southern businesses and governments. The Eurozone crisis arose when financial markets realized that this situation as unsustainable.

The fiscal and financial problems in all Eurozone countries had become deeply entangled through intra-Eurozone lending, especially purchases of sovereign bonds by Eurozone banks. As the problem economies spiraled downwards through loss of investor confidence and rising interest rates, joint Eurozone action was delayed by cross-nation hostility inflamed by populist rhetoric and ignorant stereotyping, plus the multiple veto points built into the Eurozone's intricate political and financial structure. This made a bad situation much worse by holding up Eurozone agreement to set up bailout funds and by preventing the European Central Bank from acting

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[2] http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech706.pdf

decisively like a national central bank to restore confidence by immediately offering to act as lender of last resort.

No chapter in this story is at all likely in a currency union between Scotland and rUK. They would start from very similar political and business cultures, hence very similar macroeconomic and business structures and financial parameters. So currency unification would not bring on the tensions that drove the Eurozone crisis. Were a financial crisis to arise, the two governments and the central bank could quickly agree to head off any downward economic spiral with decisive action, given their shared values and culture, virtually identical business, financial and fiscal systems, and the familiarity, goodwill and respect that obtain between their electorates.

Given the Eurozone currency crisis on the UK doorstep, it was inevitable that it strongly influence the analyses of Governor Carney and Treasury, as well as public anxiety about currency unions. However, given the differences between the two currency unions noted above, events in the Eurozone tell us little about the prospects for a sterling currency union.

3. The Scottish Government's Lack of Commitment to Currency Union?

T3. 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.

Paragraph T3 insinuates that a Scottish Government statement … "still leaving the option open of moving to a different currency option in the longer term" is similar to "what would have happened to Greece two years ago if they had said they were contemplating reverting to the Drachma". Such a statement by the Greek Government would have been foolish and irresponsible. For, already-frightened Greek bank depositors would have rushed to withdraw their deposits; the banks would have collapsed, taking down the economy. The insinuation is that the Scottish Government, which said something similar, must be foolish and irresponsible, hence unacceptable as a partner in a currency union.

Such a conclusion would be untenable, for the Scottish Government did <u>not</u> say, amidst a currency crisis, that it was contemplating an exit from the currency union. What its White Paper[3] said, as the Treasury paper noted, is that "it would, of course, be open to people in Scotland to choose a different arrangement in the future". This statement does note the possibility of exit, but well before any crisis; indeed, before a currency union has been formed; indeed, before Scotland has voted on independence. The White Paper was read, not by frightened bank depositors, but by equable voters mulling independence. The Scottish Government was presumably trying to maximize the yes vote by trying to straddle two positions: that an independent Scotland could enjoy the stability of a currency union, yet keep open the possibility of exiting it later to enjoy greater autonomy.

It was right and proper for Treasury to point out that these two positions cannot really be straddled, for "Successful currency unions are based on the near universal belief that they are irreversible". It was wrong and improper for Treasury to confound the

[3] Scottish Government (2013) *Scotland's Future: Your guide to an independent Scotland.*

Scottish Government's attempted straddle, before a currency union had even been formed, with an entirely hypothetical Greek Government statement amidst a currency crisis, which would certainly have worsened it. At worst, the Scottish Government's statement reveals naïve economics and/or disingenuous politics, but only of the sort that is routine in democratic politics. It reveals nothing about how the Scottish Government would behave amidst an actual currency crisis, as the Treasury letter insinuates.

However, a great deal is revealed by the Greek Government's actual behavior in the Eurozone crisis "two years ago". At the time, it was facing riots, 28 percent unemployment, widespread suffering and social disintegration such that 'a majority of Greeks voted for parties that want to rip up the country's bailout agreement with the European Union and International Monetary Fund (IMF) - including neo-Nazis.'[4] Yet, the Greek Government never said that it was contemplating exiting the Eurozone, because it knew that the high economic costs of an exit during a crisis would make Greece even worse off.

Scotland's economic links to rUK are wider, deeper and more intricate that Greece's economic links with the rest of the Eurozone; exiting the common currency would be correspondingly more costly. Given that the high economic costs of exit meant that the Greek Government never contemplated it during its currency crisis, the higher economic costs of Scotland's exit from a currency union with the UK would surely mean that the Scottish Government would never contemplate it during a currency crisis. This point is reinforced by political considerations.

Greeks had been in the Eurozone for only a few years: all adults remembered the good old days before; many felt tricked into the currency union by self-seeking politicians. Consequently, a proposal to exit the Eurozone during the crisis would have been politically popular, if economically disastrous. By contrast, a currency union between Scotland and the UK would merely continue a monetary system that had been shared for centuries and had overwhelming support from Scottish citizens at independence, even without advocacy by self-seeking politicians. So a proposal from the Scottish Government to exit sterling would be politically unpopular.

The Greek Government gave greater weight to the high economic costs of proposing an exit from the Eurozone during a crisis than to the substantial short-term political gains. A Scottish Government would face higher economic costs of proposing an exit from sterling during a crisis, but would enjoy fewer short-term political gains. It follows that it would never propose an exit during a crisis. It would be economically naïve and/or politically disingenuous to suggest otherwise.

But this is what the UK Government has suggested by publishing Treasury's first argument for rejecting a currency union with Scotland during a public discussion of currency options. It is therefore ill-placed to criticize the Scottish Government for being economically naïve and/or politically disingenuous in "still leaving the option open of moving to a different currency option in the future" during a public discussion of currency options. But that is the only valid point in the Treasury's first argument for rejecting a currency union with Scotland.

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[4] http://www.bbc.com/news/business-15575751

4. Scotland's Banking Sector is "Far Too Big"?

T4. 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.

T5. 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.

4.1. Logical Structure of the Treasury Claim

I first discuss these two paragraphs together in order to clarify their logical structure. They are vacuous if read literally in the context of the Treasury paper. For, this paper endorses the warning by Governor Carney that a successful currency union requires the partners to form a tight banking union, share the consequent fiscal risks and surrender substantial fiscal autonomy. If the rUK were to enter the currency union under these conditions, then its fiscal exposure to Scotland would be broadly similar to today — and the analysis of these two paragraphs would be vacuous.

So it is fair to read these two paragraphs as a warning that:

- Governor Carney's conditions for a successful currency union are especially relevant to one between rUK and Scotland, given the excessive size of the Scotland's banking sector and the asymmetry between the two economies.
- The Scottish Government is unlikely to accept the minimal conditions that the UK Government ought to impose to safeguard the interests of rUK citizens.
- It would therefore be a waste of time to start negotiations; better to rule out a currency union from the outset.

I shall critique the two paragraphs on this basis.

4.2. The Size of Scotland's Banking Sector Today

The claim that Scotland's banking sector is "far too large" is based on Treasury's computation that the assets of banks with a "registered office or principal place of business" in Scotland constitute 1254 percent of Scottish GDP, whereas that ratio is 492 percent for the UK as a whole.[5] Scotland's Finance Secretary John Swinney replied[6]:

> 'Assertions and claims about Scotland's financial sector are entirely misleading - in terms of share of GDP, in fact, financial services are actually smaller for Scotland at 8.3% than the UK at 9.6%.'

This reply compares the financial sectors in terms of the value that financial services add to GDP. But the primary risk to a jurisdiction's taxpayers is their exposure to the

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[5] Scotland Analysis: Financial Services and Banking, UK Government, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/200491/scotland_analysis_financial_services_and_banking_200513.pdf

[6] http://www.bbc.com/news/uk-scotland-22590395

fiscal burden of bailing out banks that are registered, regulated and insured/guaranteed in that jurisdiction. Arguably, the Treasury measure of the size of the banking sector in terms of bank assets provides a better indicator of this exposure than Secretary Swinney's measure in terms of value added.

But in assessing taxpayer exposure under various currency options, what matters is not the current sizes of the banking sectors in Scotland and the UK, however measured, but their sizes under the various options. This could differ substantially from their current sizes. Here, Secretary Swinney's data does provide relevant information, for it shows that much of the activity of banks that are "Scottish" in that their registered offices are in Scotland is, in fact, adding value in rUK. Such activity would provide ample justification for them to be registered, hence regulated and insured/guaranteed in rUK, should that be in their economic interest under a particular currency option.

The ratio of bank assets to GDP is high for Scotland mainly because it includes two very large international banks, the Royal Bank of Scotland (RBS) and Lloyds. These banks conduct most of their UK business in rUK — and essentially all their international business[7]. They are registered in Scotland for historical reasons, but find it commercially viable to stay registered there, while conducting their main business in England, only because they nevertheless enjoy the explicit deposit insurance and implicit guarantees of the Bank of England. The insurance and guarantees are credible because backstopped by the UK economy, which is large enough to withstand any likely liquidity and solvency risk.

4.3. The Size of Scotland's Banking Sector after Independence

How would RBS and Lloyds react to a vote for independence? Their public statements to date have been carefully anodyne, but one signal can be found in the most recent RBS annual report, which points out that:

> 'A vote in favour of Scottish independence would be likely to significantly impact the Group's credit ratings and could also impact the fiscal, monetary, legal and regulatory landscape to which the Group is subject.'

Another signal is the response of Standard Life:

> 'David Nish, chief executive of Standard Life, said the FTSE 100 pensions and savings group was preparing to shift its businesses south of the border should the Scots vote for independence. He said work had already begun to "establish additional registered companies to operate outside Scotland into which we could transfer part of our operations if it was necessary". Mr Nish said the uncertainty over currency, membership of the European Union, regulation, tax and the monetary system, were "material issues". The group employs 5,000 staff in Scotland. It has 4m customers in the UK – 90pc of whom are outside Scotland.' [8]

A third signal is Governor Carney's recent testimony to the Treasury Select Committee:

[7] http://news.scotland.gov.uk/imagelibrary/downloadmedia.ashx?MediaDetailsID=1732&SizeId=-1

[8] http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10666807/Standard-Life-and-RBS-warn-on-Scottish-votes.html

> 'Royal Bank of Scotland may have to move its headquarters to England if Scotland votes for independence this year, the Bank of England's governor has told MPs. "It's a distinct possibility but I shouldn't prejudge it. It depends on their arrangements as well," Mark Carney told the Treasury select committee on Tuesday. He was referring to a EU rule that requires banks to be based in the same country as most of their business. For RBS, which also owns NatWest and a London-based investment bank, that is England. The rule would apply if, as expected, an independent Scotland joined the EU. Carney said RBS also had the option of refocusing its business on Scotland. Carney said an independent Scotland would have to guarantee deposits held in England by Scottish-domiciled banks under EU law.'[9]

Public relations concerns will keep RBS and Lloyds mumbling about what they would do if Scotland votes for independence, so let us consider what would be rational for their international counterparties and their depositors in the situation that the Treasury letter warns against, in which the rUK is inveigled into a currency union, but without the tight banking union and tight fiscal rules recommended by Governor Carney and Treasury. The Government of an independent Scotland would then be in no position to provide credible insurance/guarantees to RBS and Lloyds: its Central Bank could not create sterling, so it could not fulfill the traditional central bank role of 'lender of last resort' during a bank run; its promise to use fiscal resources to pay off bank depositors would not be credible, since the assets of these banks greatly exceed Scotland's GDP.

The international counterparties of RBS and Lloyds would not have forgotten that, during the 2008 financial crisis, these two banks needed massive bailouts from the UK Government to meet their international obligations, bailouts that the Government of an independent Scotland could not have afforded. Those international counterparties would make it clear that they would shift their high-risk, high-fee business with RBS and Lloyds to international banks with credible insurance/guarantees, unless RBS and Lloyds re-register in rUK to secure the insurance/guarantees of the Bank of England.

Meantime, individuals and companies doing conventional business with the Scottish branches of RBS and Lloyds could easily hedge the currency risks of independence by opening an account at the nearest branch of a bank, like HSBC or Barclays, that is rUK-registered and thus, under EU law, enjoys the insurance/guarantees of the Bank of England in all their branches within the EU. To ensure that they can respond swiftly to events without disrupting their current banking arrangements, these new holders of HSBC or Barclays accounts could deposit only token amounts there, but could set up internet transfer links to their RBS or Lloyds accounts so that they can shift their banking business over there at the first sign of banking or currency risk for Scotland. If any doubt arose as to whether Scotland would become a member of the EU, they could quickly set up an account in a branch of HSBC or Barclays in rUK.

In the face of these developments, RBS and Lloyds would have no choice but to re-register their head offices in rUK. In fact, absent a tight banking union and tight fiscal rules, the international counterparties and depositors of all Scotland-registered banks would have the same reasons to be skeptical of the insurance/guarantees of an

[9] http://www.theguardian.com/business/2014/mar/11/rbs-may-move-hq-england-scotland-independence-carney

independent Scotland. The transition to independence and a new currency regime would create a great deal of uncertainty, which all Scottish citizens and businesses could hedge by opening an account with a rUK-registered bank. If the depositors in any particular Scotland-registered bank began shifting their deposits to rUK-registered banks in a slow-motion bank run, then that bank could stay in business only by becoming rUK-registered through re-registration, merger or acquisition.

Inertia and the inherently greater long-term risk of banks registered in Scotland would ensure that, even after the uncertainty of the transition to independence and a new currency regime had died down, many Scots would keep their banking business with rUK-registered banks. Few, if any, banks registered in Scotland could retain enough depositors to continue in business. In the short term, this rump of Scottish-registered banks could access the inter-bank market to make up for the deposits that risk-averse depositors had transferred to the security of an rUK-registered bank. Such funds are more costly than bank deposits; in the face of competition from rUK-registered banks, the Scotland-registered banks would eventually be forced to contract their loan portfolio to match their smaller deposit base.

The migration of banks and/or bank deposits from Scotland to rUK would continue, at least until total bank deposits in Scotland-registered banks had fallen to a level that the fiscal resources of the Scottish Government could credibly insure/guarantee in a worst-case scenario. This level would depend, not only on Scottish Government's balance sheet, but also on Scottish bank depositors' perception of its fiscal rectitude.

If depositors ever perceived the Scottish Government to be fiscally reckless, then the migration of banking business to rUK-registered banks would accelerate, disrupting Scotland's banking system in the short term and hollowing it out in the long term. Bank jobs associated with headquarter functions would shift to rUK, leaving mainly local offices where accounts are opened and closed and loan applications are processed for final approval at rUK headquarters. Scottish ATM machines would serve mainly as portals for cash deposits and withdrawals from banks registered in rUK. Scots would transact with each other mainly via Internet transfers and cheques drawn on banks registered in rUK.

In conclusion: if, contrary to Treasury advice, rUK accepted a currency union without a tight banking union and tight fiscal rules, then the Scottish banking system would no longer be "far too big", since the part that the Scottish Government could not credibly backstop with its fiscal resources would register in the rUK to seek a credible backstop from the Bank of England.

Indeed, Scotland-registered banks might vanish altogether, to be reincarnated across the border as rUK-registered banks; this would certainly happen if the Scottish Government appeared fiscally reckless. The prospect of these humiliating and economically-costly consequences of capital flight might well be a more effective constraint on the Scottish Government's fiscal plans than hectoring by rUK Treasury mandarins enforcing fiscal constraints that had been imposed upon Scotland as a prerequisite for a currency union.

5. “Asymmetry” Between Scotland and rUK?

T5. 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.

5.1. Evita on the Clyde

In this paragraph, the Treasury mandarins have whipped themselves — and perhaps the Chancellor — into a lather of moral indignation at the spectacle of the long-suffering rUK taxpayer bailing out those notorious big-spenders, the Scots, whose ungrateful pigmy nation could not conceivably reciprocate with meaningful assistance to its vast, benevolent Mother, England.

Loose talk of one nation “bailing out” another is usually to be found in tabloid headlines and populist political rants. In the real world, one nation bails out another only insofar as it joins the IMF in an international coalition to provide bridging finance on terms that allow the errant nation to escape a death spiral of rising default premia, collapsing banks and deteriorating national balance sheets. How did the Treasury mandarins persuade themselves, and the Chancellor, that vouchsafing a currency union to those dour Scots would release their inner Argentina? By confused thought.

Traumatized by the 2008 financial crisis, the Treasury mandarins presumably replayed it in an internal musical (*Alexita*?) starring independent Scotland in a tango to hell with the doomed rUK taxpayer. For, two banks registered in Scotland, RBS and Lloyds, received the biggest UK taxpayer bailouts in 2008. These bailouts were, of course, funded mainly by the taxpayers of rUK, given that its economy is much larger than Scotland’s and therefore paid much more tax. Had Scotland been independent in 2008, and had RBS and Lloyds been registered there, then Scotland could not have afforded the requisite bailouts; rUK taxpayers would surely have had to step in to bail out ‘Scotland’, given that, in the actual financial crisis of 2008, they did pay most of the bailout bill.

It is this lurid collage of fact, conjecture and fantasy, of past historical, present subjunctive and future conditional pluperfect, that lends plausibility and moral indignation to Paragraph T5 of the Treasury letter. However, if Scotland had been independent, but in a currency union with rUK in which it did <u>not</u> “cede substantially more sovereignty on monetary and fiscal matters than any advocates of independence are currently contemplating,” then RBS and Lloyds would almost certainly have shifted their registrations to rUK — as I argued in Section 4. In that case, in any replay of the 2008 financial crisis featuring an independent Scotland, the burden of bailing out RBS and Lloyds would have fallen on the rUK taxpayer. That would have been entirely appropriate, since the high-risk, high-fee activities of these banks that expose taxpayers to large-scale bailouts take place mainly in London and benefit mainly the rUK economy.

5.2. Aristotle on the Thames

Thus, the lurid collage of once and future events that underlies the indignant Treasury claims in Paragraph T5 does not comprise a consistent story, given that those claims make sense only for a currency union in which Scotland did not "cede substantially more sovereignty on monetary and fiscal matters than any advocates of independence are currently contemplating." Treasury apparently forgot to maintain this hypothesis as it set out its claims.

Instead, Treasury seems to have started out from the correct argument, implicit in Governor Carney's speech, that if Scotland did:

(A) "cede substantially more sovereignty on monetary and fiscal matters than any advocates of independence are currently contemplating," i.e., accepted the Carney/Treasury prescriptions for a tight banking union and tight fiscal rules,

then:

(B) bank bailouts are likely not to be needed and any bailout burdens would likely be shared equitably between Scotland and rUK.

Treasury then seems to have confused this correct argument with the incorrect argument that if the Scots do not cede the requisite sovereignty, then bank bailouts would likely be required, and those burdens would likely be inequitably shared. That is, Treasury seems to have confounded "A implies B" with "not A implies not B".[10] Treasury backed into this logical swamp because it had introduced the maintained hypothesis of Paragraph T5 ("not A") at the end of that paragraph, rather than at the beginning — and then did so in the ambiguous form, "unless A".

As noted in the Introduction, only subtle logical error could have led Treasury to claim, in effect, that past risky behaviour by investment bankers in London, inadequately supervised by the Bank of England, somehow disqualifies an independent Scotland to be a currency union partner of England. More Aristotle on the Thames would have meant less *Evita* on the Clyde.

5.3. The Economics of a Loose Currency Union: Better than Treasury Fears

To sort out the economics, as distinct from the logic, let us ask: what would be the overall exposure of rUK taxpayers to Scotland's financial system and sovereign under a currency union without a tight banking union and tight fiscal rules?

A banking system requires taxpayer support only under extreme circumstances. The first line of defence against macroeconomic shocks that expose imprudent lending is bank capital: bank regulators typically require banks to hold sufficient capital to absorb any likely loan defaults. The second line of defense is industry-wide insurance to protect all bank deposits and forestall depositor panic, funded by a levy on all banks. In the 2008 financial crisis, the risks hidden in complex financial products overwhelmed both lines of defence and required taxpayers to fund bank bailouts to forestall systemic collapse.

Financial collapses that require taxpayer-funded bailouts are almost bound to be due to complex, high-risk financial games that overwhelm the banking system's first two lines of defence. If rUK were to join an independent Scotland in a currency union

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[10] Formal logic shows that "A implies B" is equivalent to its contrapositive, "not B implies not A", but not to its converse, "B implies A". Hence, "A implies B" is not equivalent to "not A implies not B".

without a tight banking union and tight fiscal rules, then these financial games could be played only by banks that are registered in rUK and thus enjoy the insurance/guarantees of the Bank of England; they could not be played by banks registered in Scotland because international counter-parties would know that the Scottish Government lacks the monetary autonomy and fiscal resources to backstop the requisite transactions. It follows that, in such a currency union, the rUK taxpayer would not be exposed to large downside risks from Scotland-registered banks engaged in complex, high-risk financial games, for there would be no such risks.

What of the exposure of the rUK taxpayer to the downside risks of conventional banking after the currency union? Conventional banking in rUK-registered banks would expand with the arrival of "refugees" from the Scottish banking system seeking the insurance/guarantees of the Bank of England, as explained in Section 4. This expansion is unlikely to increase the exposure of the rUK taxpayer, since standard banking rules would ensure that the shock absorbers provided by bank capital and industry insurance funds would expand in proportion to the expansion in conventional banking business from Scotland. Any burden on the rUK taxpayer could arise only from regulatory shortcomings by the Bank of England, not by the Central Bank of Scotland.

What of the risk to the rUK taxpayer of having to bail out the rump of the Scottish banking system left registered in Scotland — or of having to bail out the Scottish sovereign? Given a currency union without a tight banking union or tight fiscal rules, the rUK would have no formal obligation to bail them out at all. When might the rUK do so nevertheless?

Perhaps under the collapse of a poorly-regulated Scottish banking system that could not be contained by the meagre fiscal resources of the Scottish Government? But when would this so threaten the stability of the rUK banking system that rUK taxpayers would be at risk? Only if Scotland-registered banks defaulted on debt held by rUK banks and this default were so massive and so concentrated in key rUK banks that it could not be absorbed by their capital or by industry insurance funds.

Given that Scotland's economy is small relative to that of the rUK and given that few, if any, banks are likely to remain registered in Scotland after independence, the above problems could occur only given extraordinary commercial misjudgment by UK banks (in holding a large quantity of dubious Scottish debt relative to their capital base) plus an extraordinary failure of oversight by the Bank of England. This possibility is minimized by the "asymmetry" between the economies of Scotland and rUK, for this makes Scottish problems less likely to overwhelm the shock absorbers provided by bank capital and industry insurance funds in rUK and thus less likely to burden rUK taxpayers.

After one such collapse, or near collapse, Scots would surely shift their deposits to rUK-registered banks that enjoy the Bank of England's insurance/guarantees and supervision. That is, the Scottish banking system cannot keep causing "UK problems": one significant problem, and it would head south by high road and low.

What of the direct exposure of the UK taxpayer to bail-outs of the Scottish Government itself? That would require:

- A fiscal policy so reckless as to threaten default on Scotland's sovereign bonds.
- rUK banks holding so many dubious Scottish sovereign bonds that the default loss could not be absorbed by their capital or industry insurance funds.

Given that Scotland's political economy has essentially the same checks and balances as that of rUK, the first condition is unlikely to be met. Given that the Scottish economy is small relative to the rUK economy, and that rUK observers would have excellent information on the fiscal state of Scotland, the second condition could arise only given extraordinary commercial misjudgment by UK-registered banks, plus an extraordinary failure of oversight by the Bank of England. Again, this possibility is minimized by the "asymmetry" between the economies of Scotland and rUK, for this makes Scottish problems less likely to overwhelm the shock absorbers provided by bank capital and industry insurance funds in rUK and thus less likely to burden rUK taxpayers.

To summarize: In the situation that the Treasury letter warns against, in which rUK joins an independent Scotland in a currency union without a tight banking union and tight fiscal rules, international banks currently registered in Scotland are likely to re-register in the rUK in order to be able to continue their high-risk, high-fee financial transactions with international counterparties; many Scottish citizens and businesses are likely to move their banking business to banks registered in rUK in order to enjoy the Bank of England's insurance/guarantees. Therefore, the rUK would face little risk of providing taxpayer support for banking activities that were "Scottish" in the sense of adding value in an independent Scotland, given that the Bank of England ought to ensure that bank capital and industry insurance funds can absorb shocks to conventional banking business by rUK-registered banks. Were these two lines of defence to be breached, the residual exposure of the rUK taxpayer to "Scotland's financial system and sovereign" would be especially small, given the "asymmetry" between the economies of rUK and Scotland. Thus, the Treasury claim that this "asymmetry" makes the exposure of UK taxpayers to "Scotland's financial system and sovereign" especially inequitable is not merely unsubstantiated: it is the reverse of the truth.

6. "Intolerable Pressure" from Misaligned Fiscal Policies?

T6. 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.

T7. 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.

The concluding sentence of Paragraph T7 is ambiguous — and evasive. The colloquial meaning of "*intolerable pressure on the currency union*" is 'pressure that is deeply offensive to its currency union partner' (as in 'Sir, your behavior is intolerable'). But, its literal meaning is 'pressure so intense that it is bound to rupture the currency union'. Why hide behind the ambiguous construction? Why not state outright that the hypothesized behavior by the Scottish government would rupture the currency union? Because that statement could not be substantiated. In other words, the claim that “there is a substantive point here” masks the reality that there is no substantive point here.

The Treasury letter criticizes the current Scottish Government’s revenue projections as over-optimistic and its fiscal plans as imprudent, then argues that this points toward similar behavior by the future government of an independent Scotland within a currency union. This ignores the different situation that the latter would face.

The current Scottish government has every incentive to paint a rosy picture and to dangle fiscal carrots before Scots deciding whether to vote for Independence. By contrast, the future government of an independent Scotland within a currency union would have to fund its deficits by sales of sovereign bonds. Such bonds would be rated as those of a nation that lacks a lender of last resort to its banking system and that cannot devalue its way out of fiscal problems. Analysts at financial institutions worldwide would scrutinize its projections on North Sea oil and gas and its fiscal plans. Implausible claims and imprudent plans would be swiftly exposed, punished and forestalled by credit downgrades, ‘sell’ recommendations on its bonds and a sharp rise in its borrowing rates.

All this would be broadcast on the nightly business news, to the embarrassment of the Scottish Government and the noisy delight of its Opposition. It would be obvious to the Scottish public that the “dashing of its expectations” of government largesse is because bond traders worldwide regard the Scottish Government’s forecasts as implausible and its policies as imprudent. Futile to blame an intransigent UK.

In this context, consider the Treasury conclusion that “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”. This is rendered plausible by the recent Eurozone crisis, wherein Greek politicians perpetually blamed continuing German intransigence for the harsh austerity measures required by the European Central Bank in return for bailout funds. Greek rhetoric, invoking ugly memories of German occupation during the Second World War, put “intolerable” pressure on the Eurozone currency union in the colloquial, if not the literal, sense.

But such ignorant, inflammatory rhetoric was possible only because Germans and Greeks had only recently joined together in a currency union and are separated by geography, language, political tradition and culture. They barely know each other, facilitating demagoguery. By contrast, Scots and English have long shared a currency — and an island, language, political tradition and culture. Scots and English know each other very well; they like and respect each other a good deal. Furthermore, Scotland, unlike Greece, is a mature polity whose citizens have long enjoyed — and today demand — responsible government, transparent institutions and intelligent public discourse. Therefore, ignorant, inflammatory rhetoric blaming English intransigence for the consequences of Scottish fiscal over-reach would be quickly dissected and dismissed by the many respected journalists, academics, and think tank analysts on both sides of the border.

So, what is Treasury’s “substantive point”? That Westminster politicians are such delicate flowers that baseless invective from Holyrood politicians (no worse than what they tolerate at Prime Minister’s Questions each week) would provoke retaliatory legislation to annul the international treaty that set up the currency union — despite the massive economic disruption that would surely ensue? That the Scots (one of the best-educated nations, famous for canniness and business acumen, continually exposed to high-quality economic analysis) would be led by kilted demagogues skirling phony grievances to abrogate the international treaty that set up the currency union — despite the massive economic disruption that would surely ensue?

There is no substantive point here. Is that why Treasury hid behind the ambiguous construction, “intolerable pressure on the currency union”?

7. Inconsistent Treasury Assumptions

T8. 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.

Paragraph T8 argues that the Government of an independent Scotland would need to earn international credibility. This is true, but implies that the issues raised in Paragraphs T6 and T7 can arise only under a legal framework that precludes the issues raised in Paragraphs T4 and T5.

Paragraph T7 worried about the “intolerable pressure on the currency union” if the Scottish Government perpetually blamed UK intransigence for the dashing of Scottish expectations. An intransigent UK could be blamed only if it had significant power over the fiscal decisions of an independent Scotland. That power could be secured only by international treaty. But Paragraph T8 argued that the Scottish Government would wish to earn international credibility. This would be undermined if it openly breached the treaty.

So the Scottish Government could blame UK intransigence for the dashing of Scottish expectations only if the two governments disagreed over how to interpret certain clauses of the treaty, for example, over the likely impact of North Sea oil and gas on Scotland’s future national budgets. The Scottish Government might feel obliged to cut back its fiscal plans in the face of more pessimistic UK Treasury projections in order to retain international credibility. It might then blame rUK intransigence for dashing Scottish expectations by insisting that Scottish fiscal plans be based on those more pessimistic projections.

But if the currency union were governed by a treaty so tight that the rUK had such power over Scotland’s banking system and fiscal plans, then there would be no reason for the concerns raised in Paragraphs T4 and T5 of rUK taxpayers’ exposure to Scotland’s financial and fiscal instability. That is why I prefaced my discussion of those paragraphs by saying that they made sense only as a warning to the rUK against a currency union with Scotland without a tight banking union and tight fiscal rules. Under such a currency union, the rUK would have little scope for “intransigence’, so the Scottish Government would have little scope for blaming that for the dashing of Scottish expectations.

Thus, the issues raised in Paragraphs T6 and T7 can arise only under a legal framework that precludes the issues raised in Paragraphs T4 and T5. So, these two pairs of paragraphs ought to have been presented, not as if they were cumulative, mutually supportive arguments against a currency union that together are overwhelming, but as different arguments that apply only under different conditions.

Since Treasury failed to substantiate any claim in any of these paragraphs, there is no substantive point here. The procedural point is one that applies to the entire Treasury letter: loose analysis and misleading exposition have diverted the debate on a grave constitutional matter onto non-issues. Indeed, loose analysis and misleading exposition have misled Treasury itself: to wax indignant in Paragraph T5 over a lurid spectacle that was manufactured entirely from its own confused thought, further diverting the debate onto non-issues.

Appendix: The Treasury Letter

(Numbering mine)

FROM: NICK MACPHERSON

DATE: 11 FEBRUARY 2014

TO: CHANCELLOR OF THE EXCHEQUER cc Chief Secretary

SCOTLAND AND A CURRENCY UNION

T0. I attach a paper by Treasury officials, *Scotland Analysis: Assessment of a sterling currency union*. I agree with its analysis and conclusions.

T1. 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.

T2. I would advise strongly against a currency union as currently advocated, if Scotland were to vote for independence. Why?

T3. 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.

T4. 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.

T5. 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.

T6. 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.

T7. 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.

T8. 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.

T9. 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.

T10. 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.

SIR NICHOLAS MACPHERSON Permanent Secretary to H M Treasury