1. Introduction

This is the first in a series of papers which sets out the Scottish Government's response to the findings and recommendations of the Fiscal Commission Working Group's Macroeconomic Framework report. This paper focuses on the choice of currency and operation of monetary policy.

Further papers from the Fiscal Commission Working Group on financial stability and the fiscal framework will follow in due course.

The Fiscal Commission Working Group consists of four eminent economists, Professor Andrew Hughes-Hallett, Professor Sir Jim Mirrlees, Professor Frances Ruane and Professor Joseph Stiglitz, and is chaired by Crawford Beveridge[1].

The members have world-renowned expertise in the areas of monetary policy, fiscal policy, and financial stability.

The Working Group was tasked with overseeing the design of a robust macroeconomic framework for Scotland. The members have made clear that they will not comment on what path Scotland should take in the referendum in 2014. The aim and remit of the group is, however, to provide advice and guidance to the Scottish Government and to offer options for reform should a vote for independence be secured.

The Working Group's first report was published in February 2013[2] and contained a series of independent recommendations for Scottish Ministers to consider. Alongside these recommendations, the members put forward a viable macroeconomic model – attractive to both Scotland and the UK – which is designed to operate from day one of independence.

The report makes clear that –

> *"the timing of the constitutional debate, and the nature of relationships and partnerships in the modern global economy, mean that much of the detail of any framework will be subject to negotiation with these partners post the referendum.*
>
> *In that respect, it is important to acknowledge that political considerations will play a role and may cloud pre-referendum comments and policy statements. However, these are likely to differ from the actual decisions taken post-referendum when agreement is likely to take place where there are common interests."* **[Paragraph: 1.19]**

[1] http://www.scotland.gov.uk/News/Releases/2012/03/fiscal-commission25032012
[2] http://www.scotland.gov.uk/Publications/2013/02/3017

The Scottish Government accepts that the nature of any framework will be subject to negotiation, and calls on the UK Government to enter into dialogue to work-up the detail of such a framework that will be attractive to both Scotland and the UK.

The outline of the paper is as follows –

- Section 2 sets out the currency choices for an independent Scotland;
- Section 3 sets out the advantages for Scotland and the UK of retaining Sterling in a formal monetary union;
- Section 4 outlines why such an arrangement would work;
- Section 5 discusses the plans for the smooth operation of such a system in practice;
- Section 6 highlights the opportunities that retaining Sterling in a formal currency union would provide; and,
- Section 7 concludes.

2. Currency Choices for an Independent Scotland

The first report of the Fiscal Commission Working Group was a comprehensive analysis of the options for Scotland post-independence. It included a detailed examination of the Scottish economy and the risks and opportunities for Scotland post-independence.

With independence there are choices in key areas such as monetary policy, financial stability and fiscal policy.

The proposed framework provides in one sense a continuation of monetary arrangements within a Sterling zone but full flexibility on fiscal policy.

As the report makes clear, the Scottish Government would have a range of new policy levers to boost growth and address inequality including; taxation, capital borrowing, welfare, social security, regulation, competition law, employment policy and immigration, helping to create a more prosperous and inclusive society. These choices would also be important for the management of risks.

One of the most important choices concerns currency.

Countries of comparable size to Scotland have adopted a range of different frameworks to suit their economic situation.

The choice of currency has a real impact on the everyday lives of the Scottish people, from the physical notes and coins in their hands and pockets, to the ease by which they

conduct business with people and companies across the rest of the United Kingdom and beyond.

The Working Group considered four options[3] –

- Sterling;
- The Euro;
- A Scottish currency pegged to Sterling; and,
- A flexible Scottish currency.

Scotland could choose any of these options and be a successful independent country.

Following a detailed analysis of the various options, the Working Group –

> *"commends to the Scottish Government retaining Sterling as part of a formal monetary union, and believes that this provides a strong overarching framework for Scotland post-independence."*
> **[Paragraph: 2.4]**

The Working Group also noted that –

> *"the preferred model would be for Scotland to enter a formal monetary union with the rest of the UK with the Bank of England (the Bank) operating as central bank for the common monetary area (the 'Sterling Zone')."* **[Paragraph: 3.29]**

The Scottish Government is clear that post-independence it will always be up to the people of Scotland, and their elected government, to decide what our currency should be. However, the present Government has the responsibility of negotiating what the best starting point would be for an independent Scotland.

Independence means having the power to decide what the best currency arrangements are for Scotland alongside other fiscal and economic powers and frameworks. We believe that retaining Sterling is the best option. The pound is currently Scotland's currency and the Bank of England is Scotland's central bank.

This is a sensible framework and would allow the day-to-day operation of monetary policy and the banking system to operate as is currently the case. This would also allow the retention of Scottish banknotes which are supported by an arrangement between the Bank of England and the commercial banks in Scotland where such

[3] A summary of the options the Working Group considered are set out in annex A.

notes are fully backed by ring-fenced assets held at the Bank. Nothing in a formal monetary union would threaten that.

All macroeconomic frameworks should have the flexibility to evolve if circumstances change, this is a key aspect of economic sovereignty.

The Scottish Government agrees with the Fiscal Commission Working Group that it makes sense to retain Sterling, in a currency union with the rest of the UK, and that it is essential to use the vital tax and other economic powers of independence to create jobs, grow the economy and build a fairer country.

3. The Advantages for Scotland and the UK of such an arrangement

After reviewing the evidence and drawing upon their expertise the Working Group stated that –

> *"Analysis shows that it would be in Scotland's interests to retain Sterling immediately post-independence. It is also the case that – post-independence – this would benefit the rest of the UK given the scale of integrated markets, including in areas such as financial services"*
>
> **[Paragraph: 3.26]**

There are a number of reasons why this would be the best arrangement, and there are a number of reasons why it would be to the benefit of both countries if such an arrangement was agreed.

It makes sense to retain Sterling as part of a formal monetary union. It will not only provide a workable currency from day one of independence but also a strong overarching framework for Scotland post-independence.

A commitment to retain Sterling would promote business certainty, reassuring businesses on both sides of the border that they would continue to trade in Sterling.

- Scotland and the UK engage in a significant amount of cross border trade. In 2011 an estimated £45.5 billion of Scottish exports were to the rest of the UK (with at least the same flow in the other direction). For both countries reciprocal trade represents a significant contribution to their respective economies.

- Scotland's natural wealth would make a positive contribution to the Sterling Area economy. For example, Oil & Gas UK estimate that North Sea output, the large majority of which takes place within Scotland's marine boundaries, boosted the UK's balance of payments by £40 billion in 2011.

- Scotland's economy represents a significant share of Sterling Area output - approximately 10% of current UK GDP or around the same size as the entire UK financial sector.

- A shared currency would help facilitate an orderly transition. For example, it would facilitate the orderly transfer of assets and liabilities which the Working Group highlighted "would seem to be a sensible and efficient solution". This would be more transparent if the debts of both countries were denominated in the same currency.

- A shared currency would help facilitate the orderly supervision and oversight of systemically important financial institutions which operate across both countries[4].

4. Why such a framework would work in practice

The Fiscal Commission Working Group determined that Scotland's economy is strong enough and sufficiently aligned with the rest of the UK that a separate currency would not be necessary.

It has been suggested that a currency union between Scotland and the rest of the UK would not work (and could even lead to some of the issues faced in the Euro zone). The Fiscal Commission Working Group concluded that "this is a false argument". Ultimately suitability to a currency union depends upon the unique structures of the particular countries and currency union in question. It is simply not a fair or accurate comparison to contrast a currency union between Scotland and the UK with that of a currency union with 17 members ranging in economic performance from Germany to Greece.

There are a number of reasons why the Scottish Government believes that a currency union would work in practice:

- Scotland and the UK have been part of a monetary union for over 300 years. This brings a high degree of integration, trade and economic mobility necessary for a successful currency union –

  - In 2010-11 over 50% of migration into and out of Scotland came from the UK.
  - Approximately two-thirds of Scottish exports are destined for the UK.

- The conditions for an optimal currency area are satisfied (for example, Scotland and the UK have similar levels of productivity and household wealth).

[4] A formal response to the Working Group's proposition and recommendations with respect to financial stability will be provided in due course.

    - Scottish onshore GDP per head is approximately 99% of the UK average (rising to 118% when Scotland's illustrative geographical share of North Sea oil is included).
    - The most recent measures of productivity show that Scotland and the UK have identical rates of productivity (in contrast, in 2011 German productivity was over 70% higher than in Greece).
    - Scotland has a stronger fiscal position than the rest of the UK.

- The economic cycles (i.e. periods of recession and growth) of Scotland and the UK are broadly aligned, although Scotland has historically had a lower growth rate (something that independence would provide the levers to address).
- Scotland and the UK also share similar institutional structures (e.g. broadly similar levels of labour market flexibility, capital market openness and investment flows).

The Scottish Government believes that these economic fundamentals, coupled with a framework that is rich and well-engineered would deliver a successful macroeconomic framework. The model proposed is fully developed to deal with any issues and provide full autonomy. Scotland would then have the opportunity to use the economic powers of independence (such as taxation, welfare, regulation and employment policies) to create jobs, grow the economy and build a fairer country.

The shape of a currency union would offer flexibility for the Scottish Government to pursue its own fiscal policies – a flexibility that existed for many years between Belgium and Luxemburg.

This will help ensure that as an independent economy, Scotland can develop and deliver policies that will improve long-term competitiveness while retaining the flexibility and ability to respond in the short-run. This is not possible under the current arrangements.

5. Practical Design and Institutional Structure

The Fiscal Commission Working Group put forward a detailed plan for how a formal monetary union could operate post-independence.

This included a framework for how governance, accountability and oversight of the Bank of England could be achieved with two independent governments – see Box 1.

It is important to note that the Bank of England is currently Scotland's central bank, just as much it is the rest of the UK's. The Bank of England was nationalised in 1946 and constitutes a UK institution. The proposed framework essentially continues that structure, albeit on a slightly more formal process.

Box 1: Summary of Practical Arrangements for Retaining Sterling

- Formal monetary union with UK, with Bank of England (BofE) as central bank.
- Ownership and governance of BofE undertaken on an explicit shared basis, reflecting Scotland's current implicit share of existing assets.
- Monetary policy set according to economic conditions across Sterling Zone.
- The Scottish Government to input into appointment process to key positions within Bank of England (for example, Monetary Policy Committee and Financial Policy Committee), its remit and objectives.
- Representative from Scottish Treasury attends MPC meetings in similar capacity to existing HM Treasury representative (i.e. in a non-voting capacity).
- Matters of collective decision making on governance addressed within an overarching agreement between both governments. An institutional arrangement, a 'Macroeconomic Governance Committee', to be established.
- Scottish Government to establish an independent Scottish Monetary Institute.

The Scottish Government is attracted by these propositions and believes that such a simple, but effective structure, would establish clear governance arrangements for the Sterling Area. It would also ensure that swift and decisive action could be taken if needed.

As the Euro crisis has highlighted, currency unions can come under stress when economic performances diverge.

The data clearly shows that Scotland is in a stronger fiscal position than the rest of the UK.

Over the period 1980-81 to 2011-12, Scotland is estimated to have run an average annual net fiscal *surplus* equivalent to 0.2% of GDP[5]. The UK is estimated to have run an average annual net fiscal *deficit* worth 3.2% of GDP.

Taking both spending and taxes into account Scotland's national balance sheet has been healthier by £12.6 billion over the past five years for which data is available (2007-08 to 2011-12).

Alongside this, the Working Group recommended the creation of relevant bodies and rules – both in Scotland and across the Sterling Area – to ensure the responsible use of fiscal policy. The Scottish Government will respond formally to the Working Group's particular recommendations with regard to fiscal policy, but we are clear that such

[5] The estimates of Scotland's public finances in this section assign Scotland an illustrative geographical share of North Sea tax receipts and GDP.

sustainability arrangements (such as debt/deficit sustainability pact) should be looked on as both necessary and desirable for both governments. Such agreements would be at the aggregate level and provide the flexibility for economic and fiscal freedom to support growth and create jobs.

It is to these details – governance arrangements for the Bank of England and fiscal rules – which the Scottish and UK Government's should look to reach agreement on prior to the referendum to ensure the people of Scotland have all the information they need to make an informed decision on the independence question.

6. Opportunities with a Currency Union

Independence within a currency union would represent a substantial step-change in the economic responsibilities of the Scottish Parliament.

For example, a currency union would provide the full flexibility to vary tax and spending decisions to target key opportunities and challenges in Scotland.

Under the current arrangements, Scotland's economic performance has lagged behind that of other comparable nations. There is no specific characteristic unique to the Scottish economy to explain this, apart from the lack of the full set of economic levers and responsibilities.

As an independent country in a Sterling Zone monetary union Scotland would have the powers to exploit our areas of comparative advantage and tackle those areas where we need to improve.

The FCWG highlighted 20 economic levers that would be available to an independent Scotland, that we do not currently have access to, and there are many more (such as employment policy and labour market issues).

Policy Opportunities Post-independence

Fiscal and Taxation	Non-Tax Based Policy
• Corporation Tax (base and rate) • Oil and Gas Taxation • Excise Duty • Value Added Tax (VAT) • Air Passenger Duty • Capital Borrowing • Welfare and Social Security • Public Sector Pay/Pensions • Housing	• Financial Regulation • Consumer Protection • Industry Regulation • Energy Markets and Regulation • EU Legislation • Competition Law • International Trade • Immigration • UK-Level Public Goods

• Rural and Environmental Taxation	• Public Provision and Procurement

Source: Box 10.1 Fiscal Commission Working Group – First Report – Macroeconomic Framework

Retaining Sterling would allow us to combine those powers with the trade and other advantages outlined above that would benefit both Scotland and the rest of the UK.

One area of particular importance is fiscal policy. At the moment, the Scottish Government is responsible for 58% of spending yet only about 7% of taxation. Under the Scotland Act 2012 this will rise to just 15% of taxation.

A successful currency union will provide some constraints on deficit levels and debt levels. However, as indicated by the Fiscal Commission Working Group –

> *"Limitations on borrowing and deficits are typically at the composite level, and still allow for flexibilities in the design of the underlying tax system and a range of specific policies suitable for each Member State. Indeed, such flexibility is vital to the success of a monetary union as it provides the autonomy and policy levers to target country specific differences (advantages and weaknesses) which cannot be tackled with a common monetary policy. This should help ensure alignment in terms of economic performance. It is also vital for democratic accountability and legitimacy."*
> **[Paragraph: 5.100]**

Therefore, and contrary to some recent statements, a currency union would not seriously inhibit the policy freedom and flexibility of an independent Scottish Government. It would instead simply ensure and promote overall financial discipline. When discussing a "fiscal sustainability agreement, the Fiscal Commission Working Group state that –

> *"there is merit in devising a 'fiscal sustainability agreement'. This should cover both governments and be credible. This would not cover individual taxes and/or spending but overall net borrowing and debt. This would provide the flexibility to develop policies to promote growth and maintain economic performance."* **[Box: 9.01]**

Moreover, Scotland's financial position would help ensure that it would be able to meet any conceivable conditions in a fiscal sustainability agreement.

Regardless of the currency option chosen there are always fiscal constraints placed upon it. Sustainable finances require clear plans and rules and the markets and external agencies (IMF, credit ratings agencies) will assess the credibility and ability to adhere to these. These constraints do exist and would even if we developed a Scottish currency. The Scottish Government has been clear that it will put in place a fiscal architecture which reflects our principles for long term fiscal sustainability.

7. Conclusion

Agreeing a formal currency union would provide a workable currency from day one of independence. It will ensure that both future Scottish and UK Governments are able to use the economic levers of independence to secure growth for their respective countries – something which cannot happen under the status quo, whilst also securing benefits for both countries in terms of trade and competition and seeing both countries play a part in securing the future financial stability of the Sterling zone monetary union.

It is only with independence that Scotland will have the ability to use economic levers to support growth in Scotland and to tackle inequality.

This paper has set out the Scottish Government's response to the key findings of the Fiscal Commission Working Group with respect to the currency options for Scotland post-independence. It has also set out the main issues that Westminster and the Scottish Government would need to discuss to operate the monetary union. There is no reason why the principles on which the monetary union would be based could not be agreed before the referendum.

Scottish Government

April 2013

Annex A: Currency Options for an Independent Scotland

	Set Up New Currency			Monetary Union with the UK	
	Join Euro	**Enter no monetary union**	**Currency Board**	**Formal**	**Informal (i.e. Sterlingisation)**
Description	• Join European Monetary Union • Monetary policy determined by ECB • Membership of ERMII for at least two years prior to joining	• New Scottish currency established • Scotland free to choose to operate either a floating or fixed exchange rate policy	• A currency board issues local notes and coins anchored to a foreign currency (e.g. Sterling) • The most robust institutional setup for fixed exchange rate regime	• Scotland enters a formal monetary union with UK • BofE sets monetary policy for Sterling Area • Formal agreement with UK Government	• Scotland chooses to retain Sterling but does not enter a formal monetary union
Key Features	• The ECB sets monetary policy for Euro Area • Implemented in Scotland by Central Bank of Scotland • One of the world's largest currency unions • Promote trade with Euro Area • Full fiscal autonomy – alongside other economic levers (e.g. regulation)	• Full control over monetary policy (e.g. set interest rates and manage liquidity in financial system) • Buying and selling of currency to maintain any currency peg (if established) • Full policy flexibility in other areas – e.g. fiscal policy	• Currency board arrangements tie the hands of monetary authorities. • Mitigate potential currency volatility • Central bank has limited opportunities to provide liquidity (beyond hard reserves of currency) • Interest rates determined by conditions in rUK only • Full fiscal autonomy – alongside other economic levers (e.g. regulation)	• BoE undertakes monetary policy for Sterling Area (i.e. interest rates determined by conditions in Scotland and rUK) • Through time opportunity to devolve certain operations to Scottish Monetary Authority • Maintains currency with largest trading partner • No major transitional arrangements • Full fiscal autonomy – alongside other economic levers (e.g. regulation)	• Limited role for central bank • No change in currency • Would not require formal agreement with UK • Limited opportunity to provide liquidity to financial system • Full fiscal autonomy – alongside other economic levers (e.g. regulation)

Source: Fiscal Commission Working Group – First Report – Macroeconomic Framework