COMMENTARY: SCOTLAND'S CURRENCY AND FISCAL CHOICES

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Angus Armstrong

Political union between England and Scotland began with the Union of the Crowns in 1603 which marked the start of a monetary union with the pound Scots pegged to sterling at a rate of twelve to one.[1] The Acts of Union in 1707 brought into effect the Treaty of the Union, where the two parliaments merged into the Parliament of Great Britain, and full monetary harmonisation with sterling replacing the pound Scots to become the legal currency of Great Britain. This monetary union has proved more enduring than any other between nations. History is strewn with famous long-term monetary unions which eventually ended.[2] In most cases, it is the breakdown of political integration which leads to diverging fiscal priorities bringing an end to the monetary union.

The Scottish National Party won the Scottish Parliamentary elections in May 2011 with the first ever majority and a commitment to hold a referendum on independence by the end of 2016. While the question(s) is yet to be decided, it seems probable that there will be a referendum on independence in autumn 2014. This will be a momentous decision in the history of the Union. Yet leaving the politics aside it is unclear what independence can deliver in an integrated world economy. Independence today involves quite different trade-offs from thirty years ago.[3] While lower cross-border barriers may have made small states more viable, there is an irony in that the same economic forces also bring substantial restrictions.[4] The enormity of cross-border capital flow means all countries are 'emerging market' economies now. Even the most powerful countries in the world have had to re-learn that monetary, fiscal and financial policies cannot be separated.[5]

This commentary considers the emerging economic framework for an independent Scotland. It looks at whether the UK or Scotland is closer to being an optimal currency area and the fiscal policy constraints on an independent Scotland, assuming it remains within the sterling area. It does not attempt to asses the viability or otherwise of Scottish independence. However, in an era where solvency constraints imposed by international markets are increasingly stringent, particularly on countries without their own central bank, we expect there will be little latitude for tax competition. There may be many intangible benefits from independence but the Scottish Parliament is likely to find the implicit financial constraints on economic policy, especially fiscal policy, are even more restrictive than being a full member of the UK.

An optimal currency area?

The rationale for a monetary union is usually framed into terms of the benefits of an optimal currency area (indeed, the original idea was based on the idea of sub-national currencies).[6] The main benefits are a predicable exchange rate and lower transaction costs, and a monetary and fiscal discipline enforcement mechanism as a basis for further integration between countries. Three common criteria used to assess the viability of an optimal currency area are: (1) integration of intermediate and final product markets with a high degree of cross-border trade relative to domestic trade, (2) capital and labour market mobility to enable greater integration, specialisation and faster adjustments to shocks, and (3)

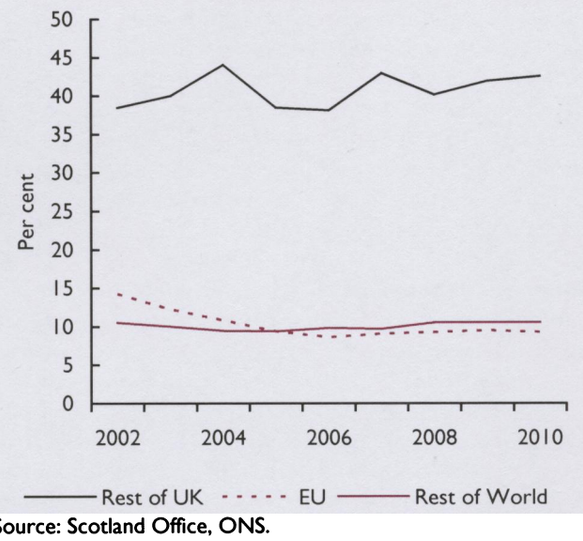
the extent to which nations have similar structures and cycles. Where these criteria are met, the benefits may outweigh the loss of domestic and occasional exchange rate policy adjustments.[7]

With the very important caveat that Scottish economic data are incomplete, a judgement can be made against these criteria. Combining official and the Scottish Government's experimental data series, the total value of exports and imports of goods and services, or all goods and services traded across Scotland's borders, is broadly the same as the value of output consumed within Scotland's borders. In economic terms, this implies that Scotland is a small and very open economy. The rest of the UK is comfortably Scotland's largest trading partner. Figure 1 uses official data to show that exports to the rest of the UK were equivalent to 40 per cent of national output or more than 60 per cent of total exports, i.e. more than exports to the rest of the world combined. Imports from the rest of the UK are an even larger proportion of output and imports from the rest of the world.[8]

Capital flow data are not available. However, some idea of the stock of direct investment by origination can be obtained from the number of registered enterprises for tax in 2010 in the Scottish Corporate Statistics by the ONS. Of these enterprises about half are companies.[9] Only 1.8 per cent of Scotland's registered enterprises are owned by enterprises in the rest of the UK. However, they account for 20 per cent of employment and turnover and almost half of Scotland's registered medium and large companies (over 250 employees). The figures are quite similar for ownership by the rest of the world with 1.3 per cent of enterprises responsible for 16 per cent of employment and 36 per cent of total turnover. The large number of Scottish firms which have been taken over by companies outside of Scotland suggests considerable direct investment inflows.[10] Of course, these figures do not tell us about Scottish ownership of enterprises in the rest of the UK or overseas.

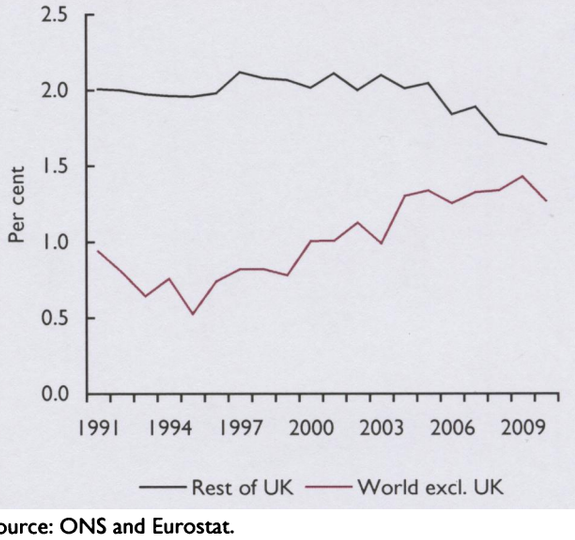
Scotland has a long history of inward and outward migration. Figure 2 shows the combined inward and outward migration flows each year as a percentage of total population. The total migration flows to and from the rest of the UK have typically been more than double the flows with the rest of the world. However, this has changed in recent years with the free movement of workers within the EU. Net inward migration from the rest of the UK is a slight positive at around 3,000 per year while net inward migration from the rest of the world is around 16,000 per year. Total flows between Scotland and the rest of the UK are still 20 per cent higher than with the rest of the world. These flows are important as the Scottish population is expected to age more rapidly than the rest of the UK. Pensions and other age-related public spending will have to be supported by a shrinking working age population.

Figure 1. Exports by destination as a percentage of gross value added



Source: Scotland Office, ONS.

Figure 2. Total inflows and outflows as a percentage of population



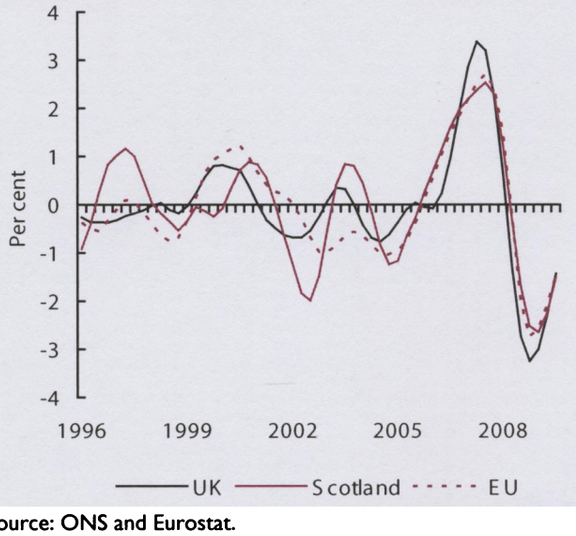
Source: ONS and Eurostat.

The most difficult criterion to judge is the closeness in economic cycles. Ambiguity over the initial economic conditions and the best measure of a cycle differ for regions.[11] Figure 3 shows the annual growth rate of real gross value added after non-linear trends have been removed by a band-pass filter.[12] This is one common measure of economic trends. The figure shows that over this period the trends for Scotland, the UK and the Euro Area are all very similar.[13] There are of course many other dimensions to cycles. The composition of Scotland's industrial structure and annual rate of retail sales price inflation are more correlated with the UK than Europe. The co-movement of cycles suggests that shocks will have a symmetric effect in both countries.

A final metric relevant to currency choice but not usually considered in the optimal currency area literature is the co-movement of asset prices. Countries can be influenced by large cross-border capital flows encouraging resources to switch from the traded to the non-traded goods sector, possibly creating a persistent current account deficit. For example, in 2006 large shares of UK mortgages were financed by overseas investors. This has proven especially problematic for the smaller countries in the Euro Area. House price cycles in Scotland and the rest of the UK are highly correlated, which is to be expected given the same sources of credit supply.

The key point of an optimal currency area is that countries which trade resources and products more with each other stand to gain most from adopting a common currency. On the basis of the assessment above, Scotland is clearly (1) a small and very open economy, and (2) more integrated with the rest of the UK than with Europe or the rest of the world. This is prima facie evidence that Scotland would benefit from continued use of sterling. However, using a currency which a parliament has no direct control over brings restrictions.

Figure 3. De-trended real gross value added



Source: ONS and Eurostat.

Fiscal and the 'current account' balance

The UK is a fiscal and monetary union. Revenues and spending are determined centrally by HM Treasury, although an increasing share of resources remain within the devolved regions. The fiscal union has two purposes: to provide risk sharing between the nations and to effect transfers to nations which may be less prosperous. Examples of risk sharing are the windfall gains from North Sea oil and the losses incurred by banks, both spread among all four nations. Transfers tend to be persistent so require a high level of public support. A successful monetary union is often characterised by an effective fiscal union.[14]

An independent Scotland would no longer be part of the UK or the fiscal union. On leaving the UK there would need to be a division of future inflows and outflows. The two largest items to be shared are the UK debt and the future North Sea oil revenues. Since Scotland's per capita gross value added is 98.7 per cent of the UK (higher than all other regions in the UK except London and the South East) there is only marginal difference between apportioning debt on a per capita or pro rata basis.[15] By contrast, the North Sea oil may be apportioned per capital or on a geographic basis relating to the position of the oil fields. The former generates 9 per cent and the latter 90 per cent of revenues approximately. Assuming nominal GDP grows by 15 per cent and using the official net debt projections between 2009/10 and 2014, Scotland's public debt ratio is 80 per cent or 70 per cent depending on how the oil revenues are shared.[16]

Estimates of Scotland's net fiscal balance (current and capital spending) are produced by the Scottish Government and shown in figure 4 below.[17] Three measures are presented depending on how the North Sea oil revenues are apportioned. Assuming the oil is apportioned on a favourable geographic basis, the average deficit over the past five years is 4 per cent of GDP. The volatility of the deficit is caused by the underlying North Sea oil revenues which in future will require managing outside of the fiscal union. It is worth noting that oil revenues will be

on a declining trend as the reserves are estimated at 35 per cent of the original fields. Current and capital spending combined are 53 per cent of GDP which is high relative to other countries.

Two important lessons from the euro crisis are (1) that having a common currency does not mean having the same interest rate on government debt, and (2) it matters whether debt is held by domestic or foreign investors. The latter point is another way of saying whether the debt was in part accumulated to finance persistent current account deficits.

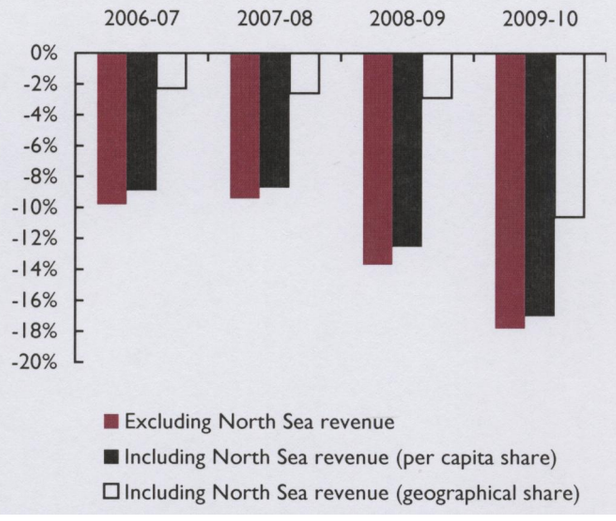
Scotland does not have international accounts, but the experimental data can be used to find a broad estimate of the external balance. Taking the balance of trade in goods and services from the national product accounts and apportioning North Sea oil to exports and expressing the balance as a share of oil adjusted output leads to an 11 per cent per capita deficit and a 5.6 per cent deficit assuming the geographic apportionment. The 2010 deficit is significantly higher than in recent years and compares to a 4 per cent average deficit over the past eight years. Gros (2011) shows that countries with external deficits and without central bank powers pay a premium on their government debt. Around one half of Scotland's external deficit is with the rest of the UK.

Monetary arrangements and fiscal policy

Governments make important choices over how they manage monetary, fiscal and financial policies. These policies cannot be taken in isolation and a choice in one domain invariably creates limits in the domain of others. In the highly integrated global financial markets the trade-off between these policy choices can be acute. Inconsistencies in policy arrangements are ruthlessly exploited. For example, monetary arrangements cannot be separated from fiscal arrangements. When a state uses the currency of another state and issues government debt denominated in that currency, it loses the ultimate response of printing money to repay creditors.[18] This creates the possibility of default. As the Euro Area crisis shows, this risk is no longer limited to developing countries.

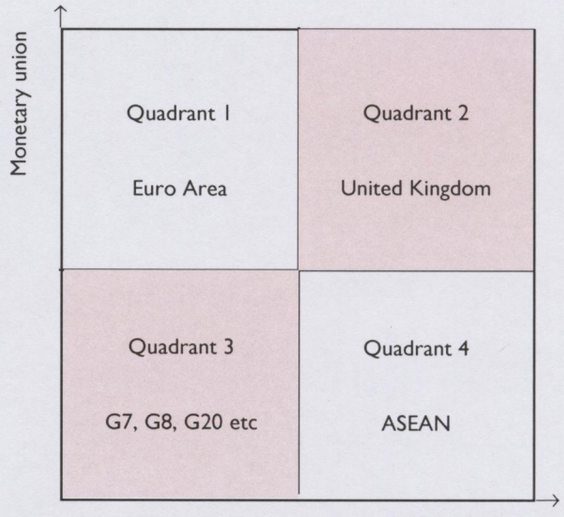
Figure 5 describes some monetary and fiscal arrangements between clusters of countries. The horizontal axis measures the extent of a fiscal union between states in the cluster. As governments are the ultimate insurers of last resort, there inevitably comes a time when fiscal policy is required to support demand. The degree to which fiscal policy can be conducted within a fiscal union by a centralised body depends on the degree of political consensus and the information to make the appropriate disbursements. The vertical axis is the degree of monetary union which shows how closely states set exchange rates.

Figure 4. Scotland's net fiscal balance (% GDP)



Source: The Scottish Government.

Figure 5. Country clusters and economic unions



Quadrant 1 describes the Euro Area countries sharing a common currency and monetary policy but with no formal risk sharing mechanism and limited fiscal transfers. Countries have no policy levers and often resort to hidden fiscal spending, contingent debt or weak financial oversight to support growth. Quadrant 2 describes the UK which has fiscal risk sharing and transfers to deal with shocks. To prevent moral hazard through over-spending or lax financial oversight, there are strict limits on public debt and common financial regulation. Quadrant 3 describes countries which belong to policy clusters but have no permanent monetary or fiscal union and allow their exchange rates to float. These are usually large countries where monetary independence outweighs the cost of exchange rate volatility. Finally, quadrant 4 describes a very limited fiscal union to address a specific risk such as the Chiang Mai Initiative where countries agree to draw on pooled foreign exchange reserves in the event of an external shock.

If Scotland gains independence the policy mix would move from quadrant 2 to quadrant 1. The Government would start independence as an indebted nation with no insurance from risk sharing or fiscal transfer mechanism. This is important for a number of reasons. First, a result of the dependence on oil revenues is that Scotland's fiscal balances are likely to be volatile with large deficits in some years. Second, when Scotland experiences an economic shock it will need to issue more debt or raise taxes to fund any spending. Given the possible debt levels, there is likely to be a premium on borrowing costs. Third, it is doubtful that the Bank of England would extend lender of last resort facilities to Scottish based institutions (as this is underwritten by taxpayers) and so a similar mechanism would require fiscal capacity to indemnify a central bank against losses. It is noteworthy that at the same time that Scotland may move into quadrant 1, the Euro Area countries are looking to move into quadrant 2 precisely to secure the fiscal union that Scotland may leave behind.

Constrained independence

Financial arrangements between countries must be logically consistent. In a world of large capital flows any compromises are eventually punished. An independent Scotland would set its own budget and issue its own bonds to finance any shortfall. Like any other country, the issue of Scottish government bonds without the ability, in extremis, to print money to repay creditors opens up the possibility of default. As some European states know this is no longer just a theoretical possibility. As a full member of the United Kingdom this possibility does not currently exist for Scotland.

If the Scots vote for independence it is likely that they will take sterling as their currency but no longer have a fiscal union. The currency choice is appropriate from an optimal currency perspective. However, assuming a favourable settlement on future oil revenues the fiscal debt is likely to be 70 per cent of GDP and estimates of recent fiscal and current account deficits have both been around 4 per cent. Scotland would be required to have some additional fiscal headroom to ensure reasonable borrowing costs. An independent Scotland is therefore likely to find the implicit constraints on economic policy, especially fiscal policy, are even more restrictive than the explicit ones it faces as a full part of the UK.

NOTES

1 The sovereign states shared the same monarch, King James I of England and King James VI of Scotland.
2 Some famous monetary unions are Latin American 1867–1927, Scandinavian 1873–1931, Austro-Hungarian 1867–1918, Soviet Rouble 1923-1991.
3 The referendum on devolution was in 1979.
4 Stevens (2012) writes that the big lesson has been about the extent to which globalised capitalism has outstripped the capacity of national governments to manage it.
5 For example, independent central banks had to ask finance ministries for indemnities in order to pursue unorthodox monetary policy measures.
7 A small country with a fixed exchange rate and with open capital flows has almost no freedom to set its own monetary policy. While this is a disadvantage for countries with a credible track record of setting policy, for those countries with no or a poor track record it is often seen as an advantage.
8 See http://www.scotland.gov.uk/Topics/Statistics/Browse/Economy/SNAP. Note, some of the trade flows may be intermediate goods at different stages of production as well as final goods.
9 Not all registered enterprises are businesses and around 50 per cent are companies, 28 per cent sole proprietorships and 16 per cent are partnerships.
10 See Kay (2011) for a summary of overseas companies which have taken over Scottish firms and some notable Scottish successes overseas.
11 The difference between GDP and GNP reflects the production by overseas owned firms. For example, GDP is much higher and grew faster in Ireland due to the presence of foreign owned businesses in Ireland. These differences for such small open economies can be large. Gross national product in Scotland is likely to be a better gauge of activity but probably lower and slower growing than the GDP measure of output.
12 The recent and early data are excluded as they are likely to be spurious due to the end point problem with filters.
13 There is some double counting here as the UK and Euro Area data contain Scotland's output. Hughes Hallett (2011) examines a time series from 1990–2009 and finds a much higher co-movement between Scotland–UK than Scotland–Euro Area.
14 Kenen (1969).
15 Gross value added is gross domestic product less subsidies plus taxes and is generally used in regional accounts where the fiscal data are collected at a national level.
16 The geographic share is based on median line rules according to the Geneva Convention.
17 Net fiscal debt includes current income and spending including capital spending.
18 This strategy also has its limits as the risk of rising inflation leads to capital flight.

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