"Separation would already be the riskiest and most uncertain step our country has ever taken……" **–**Danny Alexander MP, Chief Secretary to the Treasury, February 2014.

Alex Salmond, leader of the Scottish National Party (SNP) and "Yes Scotland" (Scotland's independence campaign) announced a patriotic date to host Scotland's landmark referendum this September. **Exactly 700 years since their famous victory at the battle of Bannockburn, on the 18th of September Scotland once again engage in battle with the English**. This time through the battle will be contested with pen rather than sword, as Scotland turns to the ballot box **to vote on independence**.

……I'll let you have Andy Murray if you let us keep the pound.

This month we explore the potential impact of the vote both sides of the border. We do know that from an economic standpoint **there are many unanswered questions for an independent Scotland**, from continuing use of the pound to EU membership, national debt and defence. Each side makes claims that the other rebuffs **and with the outcome of the vote far from certain investors should feel unsettled in the build-up**.

Perhaps the most emotive issue has been the currency. Despite being legal tender, Scottish bank notes still induce grumbles and frowns in pubs and newsagents across England and perhaps the most symbolic impact of a broken union would be the potential loss of the pound. If the pro-unionists have their way, **a vote for independence could mean a whole new currency adopted with major implications** for the Scottish economy and for the rest of the UK through transaction costs and international trad**e. George Osborne**, Chancellor of the Exchequer, pointedly **noted** in February that "….**sharing the pound is not in the interests of either the people of Scotland or the other parts of the UK**". These comments sparked retaliation from Mr Salmond. As a promoter of monetary union, he has threatened Westminster with a refusal to take on Scotland's share of the national debt if they cannot keep the pound. It's this sort of horse-trading that has rightly concerned investors and business leaders across the UK.

Re-denominating existing sterling contracts (swapping British pounds for a new currency, let's call it 'scotcoin') **would be time consuming and costly**. **There would be uncertainty as to the credibility of scotcoin as a fiat currency** backed by gold reserves **and this would likely cause Scotland's borrowing costs to rise considerably**. Also with 70% of Scotland's exports (£45 billion) going to the rest of the UK, transaction costs associated with scotcoin could make these imports more costly for the UK due to currency conversion and the risk of fluctuating exchange rates. In contrast, only 10% of UK exports go to Scotland, suggesting a smaller dependence for the rest of the UK on reciprocal trade.

Arguments against Scotland retaining the pound focus mainly on the usual examples of failed common currency experiments such as in the Eurozone. The "Yes" campaign argue that a "Sterling Zone" would work due to the alignment of the UK and Scotland's economies, 300 years of effective combined monetary policy and a shared cultural ethos. However **we would have expected that the market would be pricing in a "risk premium" for holding Sterling vs the USD and the Euro amid this uncertainty**, yet the **pound continues to have an exceptional year**, mainly on the back of ever stronger UK economic data.

A possible reason for the market's lack of fear may be the similarity between the UK's and Scotland's economies**,** as stated above.

The two follow similar economic cycles, **employment levels are broadly similar and Scotland's productivity is 99% of the UK average.** Contrast this with Germany, which had productivity levels 70% higher than Greece in 2011 and one begins to see that comparisons with the European monetary union might be misleading**. However history teaches us that such currency unions, always entered into with the best intentions, often end up in tatters** and frankly the rest of the UK would be right to wonder why they should be asked to take the risk that it fails.

Another consideration must be the **impact of another financial crisis on an independent Scotland**, where **banking assets amount to approximately 12 x GDP** compared to 5 x for the wider UK. To put this into perspective Ireland's banking assets were only c7 x GDP in the run up to the financial crisis. **Also the support package for Scottish banks in 2008 was twice the size of Scotland's national income**, **suggesting that the UK could be on the hook again should another crisis hit**.

Directly linked to currency uncertainty is the outlook for UK pensions and mortgages sold by Scotland's financial institutions. **9 out of 10 pensions sold from Scotland are to English customers** and 8 out of 10 of the mortgages lent from Scotland are to English borrowers[1]. **If Scotland establishes its own central bank to support scotcoin, mortgages issued by Scottish firms will in all likelihood be less competitive**. **Interest rates would be set at a higher level than the UK to support a more volatile currency**, as fears over the sustainability of Scotland's debt burden pushes up borrowing rates. With financial services accounting for 8% of Scottish onshore activity in 2010 these are large threats to Scotland's economy. These concerns have already prompted some of the largest Scottish based businesses, such as Standard Life, to put in place contingency plans to relocate operations to England should Scotland vote for independence.

In addition there is the **question of whether or not Scotland will have to re-apply to enter the EU**. The **Spanish government has been opposed to separatist movements** in Catalonia and the Basque Country and **could exercise its right to veto Scottish membership**.

[1]We belong together-Alistair Darling, July 2013

Spanish prime-minister, Mariano Rajoy, remarked: "….if part of a country integrated into the European Union leaves that country, then logically it would be outside the European Union, not because I say so, but because that's what the treaties say". Such a statement can only help to increase the uncertainty for Scottish voters in terms of what that entails for travel, trade, education, political standing and security. **Ejection from the EU would be disastrous for Scotland** given the impact on cross-border trade.

It has been widely agreed that in the first few years **Scotland would have to run a growing budget and fiscal deficit**. In 2010/11 Scotland's net fiscal deficit was £18.6bn but taking into account a geographical share of North Sea oil revenue, this dropped to £10.7bn so it's clear that **an independent Scotland's oil revenues are crucial** both in terms of how much of these reserves they can claim and also the price of oil . **Sadly North Sea oil and gas revenues are forecast to halve by 2017-18**[2], which doesn't bode well for those planning on putting an independent Scotland back in the black (no oil-related pun intended) based on commodity prices. The above estimates assume that oil prices will fall to $92 per barrel however the Department for Energy and Climate change assumes that prices will rise to $120 per barrel over the same period. Who is right? **The outcome could be a major factor in determining the success of an independent Scotland**.

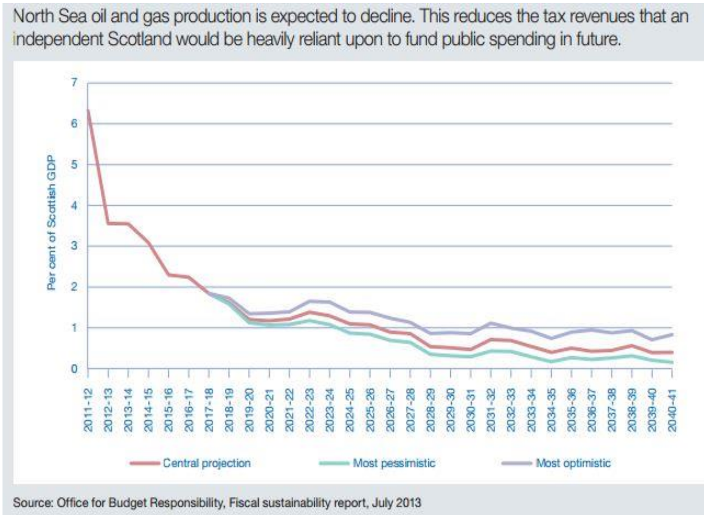
National defence is another concern with many question marks surrounding an independent Scotland's military capabilities. The **Defence industry is one of the largest employers in Scotland**, helped by the scale of UK defence spending. **An independent Scotland could see costs of purchasing and maintaining equipment of its forces pushed higher** due to smaller orders. Another major concern would be the loss of access to the UK's integral intelligence tools such as MI5 and GCHQ. The costs involved to recreate such security apparatus would be vast but without them, **Scotland would expose itself to greater risks of terrorism and cyber-attacks**.

So who can vote and what do they think about all of this? Scottish born? Just moved to England after having lived in Scotland for 53 years? Working abroad for a stint in a full time role? Not eligible to vote. You can't vote because **you must be "habitually resident" in Scotland and your permanent address must be in Scotland**. A cynic might suggest that native Scots who are travelling or working abroad are more likely to vote "No" to independence anyway and so making them ineligible to vote would work in favour of the "Yes" campaign.

Then of course there is the wording of the **question on the ballot paper**. SNPs wanted the question to be "Do you agree that Scotland should be an independent country?" which was sensibly watered down to "**Should Scotland be an independent country?**"

The current "Yes Scotland" and "Better Together" opinion polls suggest that **54% are in the "No" camp and that 35% are in the "Yes" camp**[3]. This stance seems to be shared by **the bookies** who **are offering** an average of **7/1 for those wishing to gamble on Scotland leaving the union**.

[2]HM Government – Scottish Referendum
[3]YouGov Data Study



Source: HM Government – United Kingdom, united future

Bookmakers are often good barometers of public opinion and this is a benchmark to watch in the run up to 18th September.

What do we think? Well perhaps you can tell by our biased opinion in this overview – we're in the "No" camp. It's an emotive issue and clearly many Scots find the concept of an independent nation appealing. For us **the most important concern is the uncertainty and raft of unanswered questions** that an independent Scotland would present. **We are not averse to change but we'd certainly prefer it to be based on sound economic principles**.

If, as we hope, the Scots do vote to stay in the union there are still some important considerations to bear in mind. **A majority of Scots want more autonomy**. The Scotland Act of 2012 will give more control over some areas of taxation but the three major UK parties are now proposing to grant Scotland the power to fully control income tax. **Scotland is also likely to demand a cut in corporation tax in order to attract business away from London and the South East**. **Granting these wishes poses risks across other areas of the UK** as large cities like Manchester and Birmingham could begin demanding more autonomy as they become concerned that these devolved powers enable Scotland to lure business and investment from them. **However these measures may be a pill worth swallowing in order to ensure that the greater risk of a full split is avoided**.

The wider markets appear to be siding with the bookmakers. **The pound remains strong, UK government bond yields have touched record lows and the UK equity market is fairly buoyant**. Little would suggest that investors are concerned about Scotland's vote or the consequences of the outcome. Yet **with so much of the detail surrounding independence yet to be confirmed, investors should be concerned**. After all, if Scotland vote "Yes" what hope do Great Britain have of winning another Wimbledon or winter Olympic gold?