Foreword

Along with Professor Charlie Jeffery of Edinburgh University (who is also one of our Trustees) we at the David Hume institute were delighted to be awarded funding from the Economic and Social Research Council for a series of four ‘conversations’ on issues related to constitutional change in Scotland. We are most grateful to the ESRC for this support. This paper, and its four companion pieces, is a product of our first conversation, on macro-economic policy issues and related institutional and regulatory matters.

We appreciated that we were covering a very broad spectrum in this ‘conversation’, hence the need for a diverse but exceptionally well informed set of contributions. Professor Jeffery and I, with advice from other DHI Trustees and other supporters of the Institute, agreed the areas to be covered and selected those who we hoped would provide suitable high quality inputs. It was most pleasing that all agreed to contribute. We also agreed that Hamish McRae (principle economics correspondent of the Independent) could play a valuable role in bringing together material from the papers and assisting with communications and dissemination.

The process agreed was to first seek papers, then to organise a round table debate (held at the RSE on 9th October) including inter alia all of our authors and Hamish McRae and then to hold a full DHI seminar (again at the RSE, on 19th November). The roundtable discussion was extremely valuable and we thank all of those who took part. Some of the papers were revised to take account of that debate. The seminar was also a great success, with an audience strong in terms of quality and quantity and excellent contributions from Hamish – who with immense clarity set out the key findings at the outset – and all our authors, and then an extended, vibrant and constructive question and answer session. We squeezed an enormous amount into less than two hours.

In my view all of the papers are first rate. My sincere thanks go to Cesar Colino, Paul Johnson, Owen Kelly, Gavin McCrone and Brian Quinn; and also of course to Hamish McRae. The papers were released in unedited form on our website on the 19th November and were widely discussed in the media at the time of our seminar. We have also distributed them widely to key interested parties and intend to continue to make use of them going forward – as we make progress with the next three ‘conversations’.

As is traditional I have to note that the views expressed in all these papers are those of the authors rather than of the David Hume Institute. However, I am able to stress that we believe that each of these papers is a very effective, informed and important contribution to the policy debate on one of the most important policy topics to be addressed in Scotland for many a decade. We commend each paper to you as worthy of your close attention.

Jeremy A Peat
Director, The David Hume Institute
November 2012
Scottish Independence: Issues and Questions

Introduction

An independent Scottish sovereign state would have to address a number of issues in the areas of economic and financial policy, including the appropriate institutions necessary to support and execute these policies. Any aspiring new sovereign country would have to deal with these matters. However they raise particularly difficult questions given the degree of integration achieved in the current UK economy, the shared institutions and the geographic adjacency of Scotland and the other members of the current United Kingdom.

In principle, the defining elements of a sovereign state in the area of economic and financial policy are; (i) its currency,(ii) monetary policy,(iii) public finances, including debt management; (iv) regulation and supervision of financial services; (v) crisis management; (vi) external accounts and management of foreign exchange reserves. There are other areas of economic public policy which would also have to be addressed, such as competition policy, regulation of public utilities, the boundary between the public and private sectors, industrial policy, etc. They are not considered here but would have to form part of a complete agenda.

There are two points, both obvious but of central relevance, that need to be made at the outset. First, economic and financial policies do not constitute a series of separate policy boxes, but are closely connected and interdependent. Deciding to adopt an exchange rate for a currency that is fixed in relation to another currency has very different implications for domestic monetary policy than following a free float for the exchange rate. Adopting a particular policy such as choice of the currency, without considering and thinking through the constraints that may impose on other policy areas could quickly lead to confusion at best and poor policy choices at worst.

Secondly, designing and operating new laws and institutions needed to conduct economic and financial policies is not costless. The more “separate” an independent Scotland chooses to be in terms of its core economic policies, the higher that cost is likely to be. There is no known model that is available to make the necessary calculation; and Scotland already has its own body of laws, legal system and recent experience to help in this regard. But the capital and current costs of establishing a central bank, regulatory authority and fiscal agency could be considerable and should be estimated – difficult as that might be - so that they can be factored into budgetary calculations over the subsequent short and medium term.

The current Eurozone crisis has, in a way, come at an opportune time for the debate on Scottish independence by providing an illustration of a contrasting or counter-factual example.

At the outset the broad vision of how an integrated European economy might evolve seemed clear. The formation of the single European market, removing barriers to competition and freedom of resource movements, was seen as the first step. The adoption of a single currency represented the next stage in the plan.
Deciding to take this step before including and coordinating the other areas of policy—most notably but not only fiscal policy—is now recognised to have been a profound mistake.

The backdrop to the debate on Scottish independence is almost a mirror-image. The economies of Scotland and the rest of the UK (rUK) are broadly complementary and well integrated in terms of broadly equivalent productivity, attitudes to work, payment of taxes to achieve economic and social objectives, values underlying political issues such as social welfare which are near enough shared and in support of which resource transfers to compensate for differences are well-established and accepted (Barnett and Calman). In contrast to Eurozone members, the two countries—Scotland and rUK—have developed the necessary degree of economic and social integration for an effective currency area. The case put for Scottish independence rests primarily on the opportunity for sustained higher economic growth, not on economic inequalities, where some regions of the rUK would have a stronger case.

To put it in these terms is not necessarily to say that a solution cannot be found that allows the Eurozone to survive—the odds against that appear to have shortened; or that an independent Scotland cannot find a separation model that avoids sacrificing all of the economic and financial benefits available from membership of the current UK. It suggests only that failing to get the preconditions right in terms of policy mix and institutional framework could be costly and risky.

**Policy and Institutional Choices**

(a) *The Currency*

Choosing to adopt a different, new currency from sterling would involve Scotland in establishing a central bank to pursue a policy of price stability and financial stability. Leaving aside the question of where the necessary expertise would come from—and there are precedents for hiring non-nationals, at least in the short-term—there would be difficult questions of choosing the appropriate exchange rate and monetary policy. The money and capital markets in which monetary operations would be conducted do not exist; the nature of the operational arrangements between the central and commercial banks is unknown; the range of central bank instruments for managing short-term monetary operations would have to be invented from scratch. The uncertainty surrounding the answers to these questions could create problems for financial institutions and companies in the Scottish economy; and ambitions to further develop Edinburgh as a successful financial centre could be damaged, at least until this policy and institutional framework was seen to be working successfully. Financial contracts could be denominated in sterling or other offshore currencies to eliminate the new currency risk, but there is no obvious reason why investors and companies would choose to do business in Scotland in these circumstances unless there were regulatory or tax advantages in doing so. These factors are considered separately below.
A hybrid or middle-route would be to choose a separate national currency linked in a fixed relationship with another currency. Hong Kong has successfully operated such a system for many years with the U.S. dollar as its fixed reference point. Argentina adopted a similar system in the 1990s but, in both cases, a functioning financial infrastructure was already in place. This experiment failed in Argentina because of the incompatibility of the exchange rate regime with other economic and fiscal policies. In Ireland the currency was linked in a fixed relationship with sterling for many years after becoming independent from the UK. The Irish case is perhaps the most relevant example, given the degree of integration of the two economies. Ireland chose to establish a separate currency in 1926 before joining the Eurozone for reasons that had less to do with national productivity or competitiveness and more to do with other perceived economic benefits, some of which at least are now in doubt.

A third option would be to retain sterling as the Scottish currency, a choice already announced as the preferred option by the SNP Government. The legal/constitutional questions arising in this case aside - “Whose currency is it anyway?” - and given the current problems of the Eurozone, it seems most unlikely that the current U.K. Government and Parliament would fail to set conditions for Scotland’s participation in a revised sterling zone. These conditions would include fiscal and budgetary policies, public debt management, financial regulation and supervision and crisis management. All of these areas of policy have been shown to be closely interconnected in the current Eurozone crisis.

Adopting the Euro from the outset of independence is almost certainly unavailable as an option. There is likely to be an effective qualifying period for any new prospective entrant in which those areas identified above are assessed for acceptability by the European Commission. This has been effectively confirmed in recent weeks by the President of the Commission.

The point here is to recognise that electing to retain sterling as the currency for an independent Scotland would place many constraints on its freedom of action in virtually all of the other central areas of economic and financial policy. A prospective independent Scottish Government could contest such conditions in the negotiations for a treaty governing the proposed currency union, but only up to a point. The market reaction to a refusal or serious differences over terms is not difficult to imagine.

(b) Monetary Policy

For purposes of the analysis and the implications for other policy areas, it is assumed that an independent Scotland would choose to retain sterling as its currency, as announced already by the current SNP Government. In the circumstances it is possible - even likely – that there would be no change of substance in monetary policy. But some questions do arise regarding the machinery for executing monetary policy.
There have been few, if any, representations that the policy objective, currently a rate of inflation of around 2% two years ahead, has been unsuitable for Scotland. The monetary policy best able to achieve the mix of price stability and economic growth has been the subject of much dispute in the U.K. in recent years, but this dispute has not been conducted along national lines; rather along party political lines, and even here unevenly.

In setting interest rates the Bank of England Monetary Policy Committee (MPC) currently looks at the inflationary outlook across the UK as a whole. The minutes of the MPC have never referred to significant differences in inflationary conditions, or the outlook for prices in the various regions of the UK, as a complicating factor in determining the stance of policy. This could, of course, change if the degree of integration of the Scottish and UK economies were to alter or if an independent Scottish Government favoured a very different mix of growth and price stability objectives; but this is not the likely starting point and has not featured in any statements by the SNP Government.

During the last 5 years, the Bank of England has widened the range of monetary policy instruments, partly in response to the current crisis. This has included purchasing longer term U.K. Government securities from the banking sector in an effort to reduce borrowing costs and increase money supply. It is not clear whether such instruments of monetary policy will continue to be used when economic conditions become more stable; or, if they did, how any Scottish Government securities issued post-independence would be treated. This question also applies to which securities would be deemed eligible collateral for the Bank’s normal market operations.

Suggestions that a designated member of the MPC post-independence be a formal representative of Scottish interests appear to be more political than backed by any perceived economic rationale. Countries which have adopted the U.S. dollar as their (shadow) currency—e.g. Hong Kong and Argentina—were not represented on the Federal Reserve Open Market Committee. The presence of an Irish member of the ECB Board may be a closer comparison. How much this actually matters in setting ECB policy is unclear, given the difference in inflationary performance between Ireland and other members of the Eurozone in the run-up to the crisis.

The framework for the Bank of England’s operations in the sterling money markets has also been materially changed in the last few years. This framework constitutes the machinery for implementing monetary policy, principally via the supply of reserves and the provision of liquidity insurance to the commercial banks by the Bank. The instruments employed by the Bank include its Operational Standing Facilities; repurchase operations and the Discount Window Facility. These are now key elements of the UK financial system in which the large Scottish commercial banks participate at present.
An important question in this connection is therefore whether the Scottish commercial banks will continue to function as a central part of the U.K. financial system. If Scotland does continue to be a member of a sterling currency area, the Bank of England acts as central bank for an independent Scotland, and the Scottish incorporated commercial banks continue as members of the U.K. large value payments system (CHAPS), those banks will clearly form as much an integral part of the UK financial system as they do at present. This carries important implications for regulation, supervision and crisis management which are addressed below.

(c) Public Finances and Fiscal Policy

Identifying the important issues in the area of public finance are complicated by and made more difficult by uncertainties about both the starting point and the outcome of negotiations between a putative independent Scottish Government and the UK Government regarding other key issues.

For example, the basis for calculating Scotland’s budget deficit and its outstanding public debt has not yet been agreed. Scotland’s share of revenues from North Sea Oil is very likely to be a crucial factor in any settlement on the proportion of outstanding public debt allocated to Scotland. Another imponderable is the rating which an independent Scotland’s public debt would enjoy... This is considered below.

As noted above, membership of a sterling currency area for Scotland is likely to be possible only if arrangements governing Scotland’s public finances were agreed in advance. What that might mean in hard numbers is pure speculation at this stage; but it is not easy to envisage an independent Scotland being allowed to run budget deficits or public debt ratios materially higher than those applying in the rUK. This does not mean that all room for manoeuvre or differences in the all areas of public finance would be lost. Rates of income tax, both company and personal, could presumably differ from the rUK, as well as the scope and rates of expenditure taxes. Even here, however, there could be limits arising from EU single market legislation (by which it is assumed an independent Scotland would be bound, either formally or effectively) and from any deal struck as part of a separation treaty.

Public expenditure per head in Scotland has been estimated currently as 13% higher than in the UK as a whole, while welfare spending is estimated to be 11% higher than in England and growing faster than any other category of public expenditure. These data, if accurate, imply that setting aside a proportion of North Sea oil receipts against the forecast decline in total receipts from this source, as proposed by the current SNP Government, could place further constraints on a Scottish Government’s ability to meet public finance objectives acceptable to an rUK Government as part of a deal on membership of a sterling area.

(d) Debt Management- Public and Private Sectors

It is often one of the earlier acts of an independent sovereign state to issue government debt in the markets, domestic or international. The yields on government securities set a benchmark for borrowing rates for other public sector bodies and for private sector companies.

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In a number of countries governments with no need to borrow issue securities in order to establish such a benchmark. At present there are no Scottish state obligations in issue in financial markets. Banks and companies registered in Scotland are regarded as UK borrowers and, with the appropriate adjustments for individual and sector differences issue, price and trade their debt obligations as such.

At present, UK Government debt is managed by Her Majesty’s Treasury. For new issues this involves the choice of debt instruments, their terms, including pricing, currency of denomination, maturity and timing of issue. All of these variables have to take into account the corresponding factors relating to securities already in the market. This is a complicated set of related decisions drawing on many years of experience in dealing with such matters. Given that it is not yet known what an independent Scotland’s share of outstanding public debt will be, and no indication of the size or timing of any new borrowing programme, it is difficult to determine whether Scotland should establish its own Debt Management Office, or outsource the function to a third party. This latter course is available in principle but could prove awkward, given the detailed knowledge of fiscal and other areas of public sector policy that would be necessary to do the job efficiently.

UK sovereign debt currently enjoys an AAA rating for both its sterling and foreign currency long term obligations. Ratings depend fundamentally on the capacity to meet obligations when they fall due. The principal analytical factors taken into account by Standard and Poor when making this judgement for government issues are the borrower’s political stability and pressures; its economic and growth structure; its wealth and demographics; its budgetary performance; and its existing debt burden and management. Moodys expresses its analytical criteria slightly differently: relative vulnerability to political developments; national monetary and fiscal policies; foreign currency convertibility and transfer risk.

It is not self-evident that Scottish sovereign debt, whether amounts transferred from the UK Government or newly issued debt, would enjoy an AAA rating from the outset. It seems likely that the rating agencies would wish to observe the performance of a newly independent Scottish Government before awarding a rating enjoyed by only a very few sovereign states, particularly given the recent background of perceived failure by the agencies to anticipate the financial crisis of the last 5 years. It is, of course, not necessarily the case that a rating below the highest grade would bring higher borrowing costs: the recent downgrading of US Federal Government debt from AAA to AA+ was effectively ignored by the markets. But this was a special case, given the investor appetite for a safe haven in turbulent market conditions.

As a general rule, a private sector borrower does not have a rating better than the country in which it is incorporated. But there are exceptions. Four US companies retained their AAA rating despite the downgrading of the US Federal Government debt: Automatic Data Processing, Exxon Mobile Corporation, Johnson and Johnson and Microsoft Corporation. It is also possible for a subsidiary company to have a better rating than its parent, assessed effectively on a stand-alone basis.
However known existing examples involve cases where the subsidiary company is operating in a country different from its parent company (e.g. US mortgage insurance companies incorporated in Canada and Australia). The reverse can also apply: a subsidiary company can have a rating that is lower than its parent.

Moody's also awards Bank Financial Strength Ratings (BSFRs) reflecting a bank’s intrinsic safety and soundness: they take into account risk factors such as the strength and competitiveness of the economy, the structure and relative fragility of the financial system and the quality of banking regulation and supervision. These ratings do not address the probability of timely payment but are instead a measure of the likelihood that a bank will require assistance from a third party such as its owners, its industry group or official institutions; but not the probability that a bank will receive such external support.

Clearly, how all of these factors will play out in respect of the ratings that would be awarded to an independent Scottish Government and to Scottish private sector borrowers, including banks, will depend importantly on the choices made on other issues, notably its currency and its role in a restructured UK regulatory financial system.

(e) Financial Regulation and Supervision

How an independent Scotland would deal with the regulation and supervision of its financial sector institutions is probably one of the more complex issues confronting it. There is, first of all, uncertainty about its freedom of choice under current EU laws in this matter. A senior member of the SNP Government has stated recently that regulation and financial supervision of Scottish financial institutions would continue to be carried out by the Bank of England, presumably in its proposed new role under the Financial Services Bill currently going through the UK Parliament.

This has been challenged by a senior former Scottish Executive official, and by a former Chairman and Chief Executive officer of the UKFSA, on the grounds that “each member state of the EU must have its own regulator, referred to as the ‘competent authority’ under the EU regulatory framework.” This legal question would have to be answered before any arrangements could be put in place to carry out the regulatory and supervisory functions in line with the Scottish Minister’s announcement.

It is possible that a solution consistent with existing EU statutes and with the effective outsourcing of regulation and supervision could be found, perhaps depending on whether Scottish financial institutions were deemed to be an integral part of the UK financial system post-independence. The large Scottish commercial banks have significant branches in rUK and their assets arising from business conducted with rUK customers account for a substantial share of their UK total assets. Probably more relevant is that the two largest Scottish-incorporated commercial banks are members of the UK large-value payments system through which the bulk (by value) of their daily transactions are made and settled including, most importantly, their money market and other financial dealings with other UK commercial banks.
In simple terms, the Scottish banks are an integral part of the UK money, payments and settlements system. The implications of their having to be regulated and supervised by a separate regulatory Scottish authority are far from clear, but appear to be very considerable and would need to be teased out. Examining the current arrangements in the EU and Eurozone could conceivably throw some light on these issues. Luxembourg and Belgium have banks and financial systems that have been integrated to a high degree for many years. Although each has its own separate supervisory authority at present, that is an arrangement that may not persist for long, given recent developments in the EU (see below).

If Scotland were obliged to establish its own separate regulatory authority, the cost and time required would be considerable. The formation of the FSA was announced in 1997 but was not actually accomplished until two years after the announcement; and is not an accurate guide since the FSA consisted of the amalgamation of several previously existing agencies dealing with separate services - banking, insurance, asset management, investment, etc. Likewise, the costs of establishing a separate agency and meeting its regular ongoing costs raises other questions. Presumably, as with the current UK system, they would be funded by contributions in some pre-announced form from the financial sector members but again, it is difficult to judge whether they would be greater or less than those under the proposed revised UK system.

These are not negligible issues. Given the choice of being supervised by a new, possibly more expensive and less experienced authority or by a London-based regulatory authority, Scottish financial service groups might themselves legally reorganise in order to take up the second option. Regulatory arbitrage can take more than one form.

The scope for regulatory arbitrage to exploit differences in prudential requirements would, of course, be limited by EU Directives, but not completely eliminated. The UK system has as its basis the principle that prudential requirements - capital adequacy and liquidity requirements most importantly - are set on an institution-by-institution basis rather than uniformly across the board for each class of institution. So an independent Scottish financial regulator could choose to follow the UK approach but apply it differently but still within the EU Directive minimums; or it could adopt the uniformity approach, with Scottish institutions subject to prudential requirements lower for some products and services than their UK competitors.

An important factor for financial institutions in evaluating the attractiveness of a regulatory and supervising regime is the style or philosophy of the regulator. The document recently issued by HMT entitled “A new approach to financial regulation” states that the reform is “to fundamentally strengthen the system by promoting the role of judgement and expertise…. Tick box compliance with rules has been shown to be of limited use as a model of supervision.” This is a reversion to some extent to the method employed by the Bank of England over many years before 1997, a method that places a high priority on detailed knowledge of the financial system and the financial markets, and for experience in assessing the strengths and weaknesses of those operating in these markets. These skills are not easily or quickly acquired by a new agency.
The proposed new legislation for the UK also places the Bank of England “firmly in charge not only of preserving financial stability but also leading the response when a crisis weakens stability.” The issues arising here for an independent Scotland, commonly referred to as the lender of last resort function, are examined below.

If it was determined that an independent Scotland could have its financial institutions regulated and supervised by the new UK regime, some interesting questions arise. The lines of responsibility set out for the revised system are clear, with two separate but coordinating operating agencies, the Prudential Regulatory Authority (PRA) and Financial Conduct Authority (FCA), dealing with prudential regulation of individual firms and conduct of business, respectively. These agencies will report to a macro-prudential authority, the Financial Policy Committee (FPC) within the Bank of England to monitor and respond to systemic risks. At the top of this structure the Bank of England proposes to create an oversight committee for financial stability, consisting entirely of non-executive members of the Bank’s Court. It seems likely that the UK Parliament will agree to this proposal.

The arguments for and against Scottish representation or either the Financial Policy Committee or the Court of the Bank seem to be more or less the same as those relating to membership of the MPC: on balance there appears no economic case and no need if an independent Scotland’s financial institutions remain part of the UK system; which they would appear to be on the grounds indicated above.

If an independent Scottish Government had or developed economic or social policies with priorities which differed significantly from those of a rUK government, difficulties could arise. The PRA could judge that Scottish incorporated institutions were, as a result, operating in a riskier environment and could decide that higher capital adequacy or liquidity requirements were justified, greater provisions for loss were needed, and/or higher risk weights for certain classes of bank loans were appropriate. Or if the FPC were to arrive at the view that an asset bubble was developing in Scotland that carried a threat to the UK financial system, it would have the power to intervene to correct the situation. A property boom in the UK financed predominantly by Scottish banks would be a hypothetical example of such a development.

Because it has to be acknowledged that systemic risks will always arise, and that the forms in which such risks present themselves seldom repeat exactly, problems of this kind must be expected to arise. These problems will occur whatever the constitutional arrangements in the U.K. but they would take on a much more awkward complexion if the were to arise against a background of constitutional and political independence for Scotland.

(f) Crisis Management and Bank Resolution

As with the provisions for regulation and supervision in the new Financial Services Bill expected to become law by the end of the current year, those for crisis management are designed to bring clarity to the allocation of responsibilities for dealing with crises in the UK financial sector, and to prevent or limit the damage that can arise from systemic crises. There are two important points to note here:
(i) there is no clear line between problems in an individual firm and a financial crisis. Action may be needed to prevent problems in one firm generating much wider difficulties. This is essentially a matter of judgement. (ii) a distinction is made between liquidity insurance from the Bank of England acting as the central bank in normal circumstances, and the provision of Emergency Liquidity Assistance (ELA) to firms that are at risk but considered solvent. However the provision of ELA can take place only when authorised in advance by HMT. Furthermore, it is now specified that the Chancellor of the Exchequer and HMT have, after notification by the Bank, sole responsibility for any decision on whether and how to use public funds in a crisis. These arrangements are contained in a Memorandum of Understanding on Crisis Management annexed to the new Financial Services Act; and are designed to avoid the serious problems which arose when financial crisis occurred in 2008, notably in relation to the failure of Northern Rock. They also are designed to permit the necessary actions to be taken during potentially fast-moving crises.

A key feature of the new crisis management regime is that while the Bank of England has operational responsibility for managing financial crises, the ultimate judgement and power to commit public funds lies with the Chancellor and HMT. The classic lender of last resort function is to be split, with the crucial decision to apply public funds resting explicitly with the UK Government, not with the central bank. This model makes no provision for dealing with risks to the financial system from other than UK authorised banks. Likewise the Special Resolution Regime (SRR), which sets out the options for dealing with failed or failing banks, and is operated by the Bank of England as the “resolution authority”, applies only to UK incorporated firms.

If it does not prove legally possible for Scottish financial institutions to be supervised by the Bank of England, a parallel Scottish system of crisis management would have to be established, with the necessary powers, resources and operating machinery – a huge undertaking. If Scottish financial institutions wished to be covered by the new crisis management arrangements, they would have to be supervised by the Bank of England. A special treaty acceptable to the EU covering both functions in which banks incorporated in an independent Scotland were treated similarly to rUK banks could solve some problems, but not all. The Bank of England might judge in the case of a particular Scottish bank that it should be allowed to fail since it did not threaten the UK financial system. This is a good deal more likely than before since the new crisis management arrangements aim to tackle the “Too Big to Fail“ problem. No doubt in practice such a situation have to be discussed with the Chancellor and HMT, but that would not come under the formal crisis management arrangements set out in the MOU designed to bring clarity to responsibilities in a crisis.. If it was necessary to commit public funds, whose funds would be involved in the case of (a) rescue of a single Scottish incorporated bank; (b) banking groups operating both in Scotland and rUK with members registered in both countries? Would the Scottish Government have any role in determining which option should be exercised by the Bank of England acting in its capacity as “resolution authority” when dealing with a failed Scottish incorporated bank?
Regulation, supervision and crisis management present an especially problematic mix of issues that would have to be considered pre-independence. Monetary policy; fiscal policy; debt management and regulation and supervision of financial institutions can all be involved - as they have been in the current Eurozone crisis. Regulation, supervision and crisis management are inextricably linked - but that is not a new discovery, as a reading of Lombard Street by Walter Bagehot shows.

Recent developments in the EU in the area of regulation, supervision and resolution of banks have added a further layer of complexity to how these subjects are to be addressed by an independent Scotland. In an attempt to keep the Eurozone intact, Governments have agreed the first steps in forming a European banking union which will hand responsibility for the authorisation and supervision of all banks in the Eurozone to the European Central Bank. The powers to carry out these functions are to be established by end-2012 and operations commencing from the beginning of 2014. The ECB will be accountable to the European Parliament for the exercise of these functions. It is also intended to introduce a Eurozone-wide bank resolution and crisis management system to complement the supervisory arrangements.

Non-Eurozone members of the EU may join this banking union on a voluntary basis. The UK Foreign Secretary has announced that the UK does not intend to join the banking union as it is presently set out. An independent Scotland will not be legally able to become a member of either the EU or, a fortiori, the Eurozone from the outset of independence, according to statements recently made by the President of the European Commission. How Scottish registered banks would be authorised and supervised, and bank resolution and crisis management arrangements for Scottish banks conducted, is therefore an unanswered question in the current state of knowledge.

(g) The Exchange Rate and Reserves Management

Looking at the question of the currency from another angle, it is not evident that Scotland has suffered from a chronic lack of competitiveness vis-a-vis other countries compared with rUK. However this issue is obscured by the presence of North Sea oil over the last few decades. If an independent Scotland were to achieve anything like its claim to North Sea oilfields, its external accounts could vary significantly with the oil price and its currency appreciate and depreciate in degrees that could create problems for other policy objectives. This presumably constitutes part of the case for establishing a reserve fund to help smooth out such variations in the external accounts. The task of managing a country’s foreign exchange reserves is normally carried out by the central bank, partly because of its market presence and partly because the level of the exchange rate is an element of monetary policy. Intervention in the foreign exchange market to prevent excessive movements in the exchange rate has to be coordinated with the conduct of domestic monetary policy.

While such intervention is much less common with floating exchange rates, it can still occur, as the recent experience of Switzerland and Hong Kong against the background of problems in the Eurozone indicates.
Until any reserve fund has been in being for some years, intervention to stabilise the Scottish currency would have to be by using whatever share of the UK’s gold and foreign exchange reserves was allocated to Scotland, plus any surpluses in the balance of payments – other unknowns that needs to be estimated before the full implications of independence are clear.

In this context, it is difficult to estimate how external capital flows would respond to Scottish independence. As with all other issues, it would be what the full package of policies and institutions looked like and how they were being carried out.

**Conclusion**

By choosing to announce its preference to retain sterling as the currency of an independent Scotland, the current Scottish Government has effectively surrendered its freedom to determine monetary policy and severely circumscribed its freedom of action in the area of public finance. Choosing to rely on the Bank of England to supervise its banks – and other financial institutions – may prove to be an empty choice if it proves necessary to establish its own supervisory institutions in accordance with what is understood to be EU statutes.

The structure and institutional arrangements for the proposed European Banking Union are not yet very clear. However it appears that an independent Scotland would not be able to join this banking union, and with the UK Government’s statement that it does not intend to participate, Scotland will not have the option of having its banks supervised by the ECB under the new EU framework; likewise the bank resolution and crisis management systems.

On a strict interpretation of EU statutes this would mean that an independent Scotland would have to establish its own regulatory and supervisory system de novo. That would take much time and would create uncertainties for both the European and UK financial systems that would be unwelcome. However the negotiations which will take place regarding the transfer of powers from national authorities to the ECB with the formation of the European Banking Union may permit both the Scottish and rUK Governments to raise with the European Commission the possibility that the arrangements for authorisation, regulation and supervision of Scottish banks, and for crisis management, should rest with the rUK Government and the Bank of England.

Such an outcome would avoid the uncertainty and expense entailed in setting up a new and untested institution within the EU, but would not remove other issues such as the prudential requirements and deposit insurance for Scottish banks. However it is difficult to envisage the rUK Government agreeing to significant differences between the requirements applying to Scottish and rUK banks in these circumstances. It would also leave unresolved the question of how the financing of the crisis management arrangements would be determined. Thus even this fall-back solution would also limit the freedom of choice for an independent Scotland in this important area.
The David Hume Institute
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