The Aerial View
Market Update

The Pound Scots

- Shifting politics in Westminster mean a second independence referendum in Scotland could still emerge
- Early adoption of a separate currency in event of a vote in favor of independence is now party policy for SNP
- Likely that this would need to happen even if intention was ultimately to join EUR

There is little appetite at present within the government in Westminster to consider a second referendum on independence in Scotland. However, it is hard to know what agreements might be reached between coalition partners should a general election emerge in the near future. It is therefore not outside the bounds of possibility that a second referendum could emerge.

While opinion polling on independence appears to have been relatively sparse this year, a poll published by YouGov/The Times in recent days shows just a two percentage point gap between Yes (leave) and No (remain).

Given this, it seems an appropriate point to consider recent developments on the question of what currency Scotland might use should it vote to become independent.

SNP annual conference

The Scottish National Party's annual conference produced an unexpected development on the question of what currency Scotland might use. Rather than support a motion that the currency of an independent Scotland should continue to be GBP until a separate currency "can be safely and securely established", the conference voted to replace GBP
with a separate Scottish currency "as soon as practicable" after independence.

So what options does Scotland realistically have?

1: Continuing to use GBP

While the then leader of the SNP, Alex Salmond, pushed in 2014 for a currency union with the rest of the UK he was met with robust opposition from London (it’s worth noting that the UK is in a currency union with Jersey, Guernsey and the Isle of Man).

While the government in London might refuse to enter into a currency union with Scotland this does not mean that Scotland couldn’t continue to use GBP for some while. However, it means that Scotland would have no say over monetary policy, nor have a lender of last resort for its banking system.

Standard & Poor's highlighted in 2014 at least one of the risks for Scotland from "sterlingization" when it said there were "important considerations and uncertainties" that factored into the creditworthiness of banks should Scotland vote for independence.

The rating agency said it counted the existence of a Scottish central bank, the Scottish government's attitude towards helping struggling banks, changes to financial regulation and independent Scotland's currency among crucial factors that could impact its ratings on the country's banks. It added: "The willingness and ability of the Scottish government to support its banking sector appears challenging".

It seems clear that "sterlingization" could only provide a temporary solution for Scotland on the question of what currency it should use. Nevertheless, up until this weekend this looked the most likely option for a reasonable number of years, should Scotland vote for independence.

2: Adopting the EUR

Membership of the European Union is a prerequisite to be considered for membership of the EUR. It is therefore unlikely that Scotland could become part of the single currency straight away (particularly when the Catalan issue continues to reverberate).

Nevertheless, it is possible that, much like Montenegro and Kosovo, it could use the EUR without being part of the euro area. Still, this raises exactly the same issues as using GBP when it comes to the matter of setting monetary policy or having a lender of last resort.

Indeed, it could also be argued that the monetary policy settings of the ECB are likely to be even less suited to the needs of Scotland in the immediate future than those of the BOE.

It is also worth noting that Olli Rehn, former European Commissioner for Economic and Monetary Affairs, said in 2014 that it "would simply not be possible" for Scotland to join the EU if it adopted so-called "sterlingization". In other words it needs its own currency first and the appropriate monetary authorities if it was to join the EUR.

3: Re-launching the Pound Scots
Prior to the 1707 unification of the Kingdoms of Scotland and England, the unit of currency north of the border was the Pound Scots. It is entirely possible that a newly independent Scotland could relaunch the currency and establish its own central bank.

However, while this would be the most sensible long-term option (even if the aim was to join the EU and then the EUR), establishing the appropriate infrastructure (including the creation of a new central bank) would still take time.

In the absence of a temporary currency union (with assurances being made on both sides) to provide support to the financial system in the interim should it be needed, this could leave Scotland in an uncomfortable position for several years.

**Share of the national debt**

Speaking in Aberdeen in February 2014, Mr Salmond said: "If there is no legal basis for Scotland having a share of the public assets of the Bank of England, then there is equally no legal basis for Scotland accepting a share of the public liability of the national debt." In other words, if there was no currency union then Scotland didn't intend to pay its share of the national debt.

This point was reiterated by Sir James Mirrlees, Nobel Prize-winning economist and a member of Scotland's Council of Economic Advisers in an interview with *The Daily Telegraph*.

He stated: "Britain inherits the debt. It is hard to see how Scotland can take on the debt unless there is a full currency union. This is implied by the hard-line taken by Westminster. It is Scotland's bargaining position."

The potential impact of Scotland renouncing its share of the national debt was spelled out by Fitch Ratings in April 2014. It noted: "As we have previously emphasized, the UK’s gross debt ratio will need to be lower than its current level and steadily declining before any upgrade back to 'AAA'; a prospect that would be delayed by such a debt shock".

**Final thoughts**

The Scottish currency question has largely fallen off the radar since 2014. While it doesn’t look as if it will be an issue for the markets in the immediate future, it’s clear that it could come back as a topic for discussion later this year, dependent on how the labyrinthine politics in Westminster play themselves out.

It’s therefore a good time to be reminded of the issues.

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